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Stock investing from an Islamic perspective and the uncertainty of gharar

Kamal, Omar Marwan

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STOCK INVESTING
FROM AN ISLAMIC PERSPECTIVE
AND THE UNCERTAINTY OF *GHARAR*

OMAR MARWAN KAMAL

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ABSTRACT

Gharar (excessive risk or uncertainty) is prohibited in Islam and its presence in financial contracts makes these contracts null and void. The prohibition of *gharar* can also extend to investing in stocks. Very few studies have investigated how *gharar* affects stocks investing. Consequently, very few studies suggest tactics and strategies that can be employed for *gharar* reduction in the case of stock investing.

The thesis attempts to investigate the topic of *gharar* in terms of stock investing. The thesis is far from developing a theory of *gharar* in terms of stock investing, however it is an attempt to establish the foundation for rationalising and understanding *gharar* in terms of stock investing. For this purpose, the thesis employs qualitative analysis, and depends on different types of secondary sources of information. The thesis extensively interprets and presents findings, and analyses the data derived from scholarly writings on the topic of *gharar*, which can be found in journal articles, books and several conference papers.

The thesis also examines a sample of the screening criteria of Islamic Equity Funds (IEFs), since it is the only indicator explaining the guidelines Muslims pursue when tending to invest in stocks. In this regard, the sampling strategy employed is Critical Case Sampling. The thesis examined all Islamic Equity Indexes and a number of the major Islamic Equity Funds. It has been found that the screening criteria of Islamic Equity Funds is limited to two matters: (1) excluding firms that are associated with impermissible activities and operations e.g. financial services firms and casinos, and (2) excluding firms highly involved with interest-rate based transactions.

Despite the fact that screening criteria of Islamic Equity funds are supposed to be strictly derived from the basic tenets of Islamic law, thus far, *gharar* is excluded from these screens. For the purpose of incorporating *gharar* into the screening criteria of Islamic Equity Funds, the thesis first suggests a definition of *gharar* in terms of stock investing, which is based on the commonalties found in the different interpretations of Muslim scholars of *gharar*. Muslims need to focus on avoidable (controllable) risk in a proper manner, and attempt not to rely on pure chance in achieving the desired profit or return. Secondly, the thesis suggests a number of conventional strategies for risk reduction that can be successfully used for *gharar* reduction. Thirdly, the thesis explores the different conventional stock valuation models e.g. Value Investing, Modern Portfolio Theory (MPT) and Derivatives. It has been observed that the different types of derivatives in Islam are prohibited for several reasons. Several tactics and ratios derived from Value Investing and MPT can be successfully used to for *gharar* reduction purposes. In regards to Value Investing, the following ratios and tactics can be used for *gharar* reduction: different Multiple ratios, long-term investing, intrinsic value and fundamental analysis. Two main issues can be beneficially derived from MPT: the portfolio approach and beta ratio. However, note that several modifications have been performed on these suggested ratios and tactics in order to comply with the basic tenets of Islamic contract law. Last but not the least, both Value Investing and MPT fall short of assessing any non-financial but nevertheless fundamental activities of the firm.

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CHAPTER 1

RESEARCH BACKGROUND AND CONCEPTUAL FRAMEWORK

1.1 Introduction

The Day of Judgement (Resurrection) is a significant element in Muslim thinking today. On this day, Muslims believe that humans will be judged according to their conduct and belief. God's judgement will take account of all factors. Those who have obeyed God's commandments will dwell forever in paradise, but those who have sinned against God and not repented will be condemned eternally to the fires of hell. Many verses in the Quran speak about the Day Of Judgement using either "vivid images" or "striking metaphors". [1]

Muslims believe that individuals, societies, and governments should all be dutiful to the will of God as it is set forth in the Quran. Muslims also believe that their religion is "comprehensive" and covers the different aspects of life. One of these aspects pertains to Islamic "contract" law. Vogel and Hayes summarize the basic tenets of Islamic contract law in two points. First, the ultimate ownership of property is God's. Secondly, the "contract" is a "moral" and "legal" means to attain property. In this context, a "lawful" gain or income in Islam is based on mainly two concerns; "ethics" and "contract law". From these two concerns, the prohibition of "*maysir*" (gambling) and "*riba*" (increase) are justified in Islam.[2]

Property is central in Islamic finance, since the different sources of Islamic contract law; starting from the Quran and ending up with contemporary Muslim jurists, have

1 Goring, Rosemary, ed. (1992), Chambers Dictionary of Beliefs and Religions, Chambers, New York-USA, p. 273.

2 Vogel, Frank and Hayes, Samuel (1998), Islamic Law and Finance: Religion, Risk, and Return, Kluwer Law International, Massachusetts-USA., p. 68.

extensively emphasized the importance of the fact that Muslims are only permitted to earn and deal with *halal* property. For instance, the following two verses are from the Quran and are related to property:

> Eat of the things which God hath provided for you, lawful and good; but fear God, in Whom ye believe.[3]
>
> O ye who believe! Eat not up your property among yourselves in vanities: But let there be amongst you Traffic and trade by mutual good-will: Nor kill (or destroy) yourselves: for verily God hath been to you Most Merciful![4]

In the first verse, God asks believers to eat what is provided to them in "lawful and good" manners. In the second verse, God prohibits Muslims from utilising their property in "vanities". From these two verses and many others in the Quran, it can be concluded that Muslims are concerned in earning *halal* income i.e. income that is only generated from trades and activities that are consistent with Islamic contract law. It can be interpreted that investing in stocks is one of the "things" God provided, and hence, Muslims are obliged to invest in such stocks in a "lawful and good" manner.

In a certain way, the latter could be similar to many contemporary transactions. For instance not long ago, social and ethical-based funds have avoided investing in the so-called "sin stocks" such as alcohol and tobacco manufacturer. Roman Catholics and other similar religious groups have clearly opposed abortion and birth control related issues; consequently, hospitals that provide such medical services were excluded by the social screens of these funds. Today, social and environmental screens are much more comprehensive. These screens are not only restricted to tobacco and alcohol

3 The Quran: al-Ma'idah [5:88].

4 The Quran: an-Nisa' [4:29].

issues, but include issues such as "diversity in the workforce", "women in upper management positions" and "human rights policies". [5]

Initially, Muslims until these days, did not have any stock markets that only offer Islamic lawful (*halal*) stock. Stock markets available in Muslim countries are very similar to the stock markets available in the West. These Muslim stock markets contain *riba*-based financial firms, conventional firms, and firms that own hotels serving alcohol; even stocks of local gambling firms are traded in a number of Muslim countries e.g. Malaysia. Furthermore, there is no "unified" style that can be regarded as an "Islamic style" for investing in stocks. There are many issues that can be derived from the different sources of Islamic contract law and can be interpreted as limitations that restrict Muslims from particular investing acts and decisions.

Having said that, Islamic banks and other related financial firms have recently been focusing in the business of stock investing. These banks started offering so-called "Islamic Equity Funds". The first Islamic Equity Fund (IEF) was constructed in 1986 under the name "Amana Income Fund". The fund was, and is still, managed by Saturna Capital Corporation; an asset management company based in Washington[6]. Currently, the total number of Islamic Equity Funds is around 100.[7] The rationale for the surge is the anticipated demand generated from the 1.2 billion Muslims around the world, specifically those institutional investors and wealthy individuals that are based in the Arab Gulf region. The main purpose of these funds is establishing a modern

5 CNN Financial News, available at: http://cnnfn.cnn.com/1999/03/26/investing/q_social/, Internet, last accessed at 16/4/2001.

6 Al-Rifai, Tariq, Islamic equity funds: a brief industry analysis, available at:www.failaka.com, Internet, last accessed at 12/09/200.

7 Failaka International Fourth Quarter 2000 Report, Failaka International Company.

"Islamic friendly" investment tailored for Muslims interested in stock investing. Initially, as these equity funds are called "Islamic", they are supposed to operate according to the basic tenets of Islamic law. In general, every IEF has its own *Shariaa* Supervisory Board (SSB), and the members of this board ensure that the IEF is operating according to the basic tenets of Islamic law.

Islamic Equity Funds are, in certain aspects, similar to "ethical" equity funds promoted in the West, especially when it comes to the techniques employed for dividing "lawful" stocks from "unlawful" ones. Yet, the set of criteria in "ethical" based equity funds and IEFs is different.[8] For instance in the case of Social Equity Funds or Socially Responsible Funds promoted in USA, the fund manager employs a "social screen", and hence, firms with "negative social behaviours" are excluded. Therefore, firms that produce tobacco or are involved in the gambling business are screened out. In the case of environmental-based equity funds, all firms that pollute the environment are screened out. With regard to Islamic Equity funds, the central issue is that guidelines underpinning the screening criteria are supposed to be derived strictly from the basic tenets of Islamic law. Thus far, the fund manager in the case of IEFs employs qualitative and quantitative analysis. The current purpose of these analysis is limited to two matters: (1) excluding firms that have impermissible activities and operations e.g. financial services firms and gambling firms, and (2) excluding firms highly involved with interest based transactions. In addition, the fund manager of an Islamic Equity Fund is banned from employing risk-hedging

8 In USA, ethical based funds are either called Social Equity Funds or Socially Responsible Funds. Note that the term "social" does not mean that the purpose behind these funds is limited to charity giving.

conventional techniques e.g. futures contracts, option contracts, and swaps. The fund manger must also avoid dealing with preferred shares, short sales, and margin trading.[9]

The thesis emphasises on the screening criteria of Islamic Equity Funds and Indexes, since these are the only practical application of the approach Muslim investors apply when it comes to investing in stocks. By putting these criteria under the spot light, we might be able to explore the following questions. What is the basis of the screening criteria of Islamic Equity Funds and Indexes? Do these criteria conform with the basic tenets of Islamic contract law? Are the basic tenets of Islamic contract law limited to screening out firms involved in *riba* and other specific type of businesses? Or are there any important aspect(s) that need to be considered in these screens?

In particular, the literature on the different sources of Islamic contract law has referred to a third major aspect which has not been included in the screening criteria of IEFs. This aspect is *gharar* (excessive risk or uncertainty). There is unification among the different Islamic *fiqh* schools on the unlawfulness of *gharar*. However, the definitions of *gharar* presented by these scholars create ambiguity. In addition, these scholars disagree when it comes to the "degree" of *gharar* that invalidates a contract. At this stage, the central point is to make clear that there is no doubt that *gharar* is prohibited in Islam. Ibn Rushd (Averroes) asserts that:

9 Dow Jones University, Principles of Islamic Investing, Dow Jones & Company, available at: http://ws1.dju.com, Internet, last accessed on the 28/2/2000.

If we consider the causes by virtue which of a sharia prohibition attaches to contract, and which are general causes of invalidity (affecting all or most contracts, and holding across the types of contract), there are four: (1) the prohibition of the thing which is being sold (e.g. Wine or pork), (2) *riba,* (3) *gharar* and (4) those terms (*Shurut*) that conduce to one of the last two or some combination of them. [10]

10 Ibn Rushd, Muhammad Bin Ahmad (1981), *Bidayat al-mujathid wa-nihayat all-mugtasid, Mustafa al-Babi al-Halbi*, Cairo, pp. 125-126.

1.2 Previous Studies

This section highlights the several studies that have tackled the topic of *gharar*. A limited number of these studies tackle *gharar* particularly in the context of stock investing. The purpose behind most of these studies is not limited to *gharar* in terms of stock investing, There are more comprehensive and therefore include many other issues related to *gharar* directly and indirectly in the context of stock investing.

Al-Suwailem in his paper titled "Towards an objective measure of *gharar* in exchange"[11] puts a serious effort into developing a framework for analysing *gharar* based on the economic aspects of "game theory". The author defines *gharar* in exchange transactions as equivalent to a "zero-sum" game with "uncertain" payoffs. A zero-sum game is in which whatever one party gains is what the other loses i.e. "strictly competitive games". The opposite of this type of game is the so-called "non zero-sum game", and the results in this case are win-win, win-lose and lose-lose. Al-Suwailem also asserts that in many respects, "stock markets are viewed as gambling casinos", and in this sense, these markets are considered *gharar*, and therefore bear a strong resemblance to gambling. Having said that, the author in a later stage of his paper declares that there are also cases whereby the stock markets could not be viewed as lotteries, and the result of the former might not be a zero-sum game. The justification made by the author is that there are situations where all participants in the stock market might win especially when "economic conditions" are favorable; whereas "collective" winning in a lottery is impossible, it is feasible in a stock market.

11 Al-Suwailem, Sami (1999-2000), Towards an Objective Measures of Gharar in Exchange, Islamic Economic Studies, Oct-Apr., Vol. 7, No. 1 & 2, available at: http://islamic-finance.net/islamic-exchange/, Internet, last accessed at last accessed at 03/03/2001, pp.61-102.

Therefore, in this case a lottery is a zero-sum game but *gharar* and the stock market is not.

In the conclusion of the paper, the author asserts the following:

> … uncertainty or risk is what tempts rational agents to engage into an exchange which they know in advance that only one will gain from it while the other must lose. This temptation is best described by the term *gharar*, which means deception and delusion. It follows that a *gharar* contract is characterized as a zero-sum game with uncertain payoffs. This paper argues that such measure well defines *gharar* transactions. [12]

El-Gamal[13] criticises Al-Suwailem's approach of quantifying *gharar*. The former mentions that Al-Suwailem's argument fails to explain the economic matter of the prohibition of *gharar* in classical jurisprudence. Indeed, El-Gamal suggests many examples of pure zero-sum games, which are not banned on the grounds of *gharar*, and other contracts that are banned because of *gharar*, although they are not near-zero- sum. Based on this problem, El-Gamal suggests in his paper "An Economic Explication of the Prohibition of *Gharar* in Classical Islamic Jurisprudence", a different method of justifying the prohibition of *gharar* in contracts. El-Gamal argues that "riskiness" by itself is not sufficient to consider a contract invalid. He claims that the prohibition of "*bay al-gharar*" is best translated as "trading in risk". The author suggests applying "cost-benefit" analysis for the purpose of distinguishing between the permission or prohibition of a contract which embodies *gharar*. He argues that "trading in risk" is, in most cases, "inefficient" and especially when it is compared to other forms of risk sharing. The author also points out that the injunction against "trading in risk or *gharar*" can be explained based on more subtle considerations of

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12 Al-Suwailem, Sami (1999-2000), Towards an Objective Measures of Gharar in Exchange, Islamic Economic Studies, Oct-Apr., Vol. 7, No. 1 & 2, available at: http://islamic-finance.net/islamic-exchange/, Internet, last accessed at last accessed at 03/03/2001, p. 98 (61-102).

13 El-Gamal, Mahmoud (2001), An Economic Explication of the Prohibition of Gharar in Classical Islamic Jurisprudence, First version, available at: http://www.ruf.rice.edu/~elgamal/files/islamic.html, Internet, last accessed at 03/03/2001.

economic inefficiency arising from the mis-pricing of risk. The author also clarifies that trading in certain amounts of risk can be allowed as an "exception" if the risk is "minor" or if there is an "economic" need for the contract even if it embodies substantial risk.[14]

Naughton and Naughton [15] attempt to examine the structure and practices of stock markets from an Islamic perspective. Despite the authors' emphasis on "speculation" which (according to the authors) is unacceptable in Islam, they do not touch and refer to the subject of *gharar* in a direct manner. The authors assert that the prohibition of speculation in Islam is due to its association with "gambling" and "excessive risk taking" in which both create "volatility" in stock markets. In addition, the profits of speculators are achieved at the expense of other investors.

In the same paper, Naughton and Naughton propose a number of steps for the purpose of controlling speculative trading in stock markets. One of the main steps is applying "price limits" on the daily movement of stock prices. The authors illustrate:

> Price limits are used in the stock markets of Japan, Korea, Malaysia, Taiwan and Thailand. In these markets the price of any stock is not permitted to move up, or down, by more than a percentage of the opening price. .. When a stock reaches the price limit, trading does not halt. Investors may continue to trade in the stock, but only at prices within the limit. The objective is to limit the ability of speculators or manipulators to push the price too much in either direction in a short period.[16]

14 El-Gamal, Mahmoud (2001), An Economic Explication of the Prohibition of Gharar in Classical Islamic Jurisprudence, First version, available at: http://www.ruf.rice.edu/~elgamal/files/islamic.html, Internet, last accessed at 03/03/2001.

16 Naughton, Shahnz and Naughton Tony (2000), Ethics and Stock Trading: The Case of an Islamic Equities Market, Journal of Business Ethics, Jan 2000, Vol. 23, Issue 2, Part 2, pp. 145-159.

16 Naughton, Shahnz and Naughton Tony (2000), Ethics and Stock Trading: The Case of an Islamic Equities Market, Journal of Business Ethics, Jan 2000, Vol. 23, Issue 2, Part 2, p. 154 [145-159].

p. 154.

Chapra tackles the issue of "speculation" in stock markets without referring directly to *gharar*. He argues that the purchase of stocks on a "margin basis" increases the degree of speculation in stock markets. In order to support his argument, the author cites the crash that took place in the American stock market in 1987. In this context, he asserts that it is very hard to justify any "fundamental change" within the "precipitous plunge" of 22 percent in stock prices.[17] At the end of the paper, the author suggests a number of reforms designed to curb speculation, he asserts that the:

> Continued sanity in the stock market could only be attained through a number of reforms. The most important of these being the abolition of short "sales" and the imposition of a 100 per cent margin, which implies that buyers can make only cash purchases. These reforms will put an end to options and derivatives which permit the speculator to take a large position with a small amount at risk. [18]

Chapra also emphasises on the real purpose of financial markets. He pictures the stock market as a platform to channel household savings into productive investments for boosting employment and output. The problem is that speculation in stock markets has a reverse impact on their real purpose, speculation rather diverts resources away from productive activity. The author cites the Nobel Laureate, Prof. James Tobin as evidence to his argument. According to Tobin:

> … very little of the work of the securities industry, as gauged by the volume of market activity, has to do with the financing of real investment in any very direct way. Likewise those markets have very little to do, in aggregate, with the translation of the saving of households into corporate investment. [19]

Obaidullah [20] in his paper "Regulation of Stock Market in an Islamic Economy", emphasises on the importance of "fairness" in Islamic stock markets. In order to

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17 Chapra, Umer (2000), Alternative Visions International Monetary Reform, Paper Presented in Fourth Conference on Islamic Economics and Banking, Loughborough University, August 13-15, UK.

18 Ibid., p.443.

19 Tobin, James (1984), On the Efficiency of the Financial Systems, Lloyds Bank Review, July 1984, p. 1 (1-5).

20 Obaidullah, Mohammah (2000), Regulation of Stock Market in an Islamic Economy. Paper presented in the Fourth International Conference on Islamic Economic & Banking: Islamic Finance: Challenges & Opportunities in the Twenty- First Century, August 13-15, 2000, Loughborough University, UK.

ensure "fairness", the author suggests a number of norms that are mainly related to the prohibition of *riba* and curbing "excessive risk". The author suggests three norms related to *gharar*:- settlement risk, inadequacy of information and complexity in contracting.

The author also suggests an objective measure of *gharar*. The concept adopted is the same one suggested by Al-Suwailem. Obaidullah divides the individual participants in stock markets into "speculators" and "value investors". For the value investor, it is a "co-operative" game, for speculators, it is a zero-sum game i.e. "competitive". The author argues that once the stock market is monopolised by the "speculation motives", it is involved in *gharar*.

Obaidullah in his analysis, assigns the stock market regulators a central role for the purpose of reducing *gharar*. He illustrates it thus:

> Though if the intention of an individual is largely unobserved and hence, he may not be prohibited from playing the game on this ground, a regulator is expected to be governed by macro-level considerations. Though we cannot categorize a given individual investor as a speculator or a value investor, we can certainly say whether at any particular time, the investors, as a community are dominated by speculation motive or investment motive. [21]

There is an important opportunity to gain from these previous studies especially when it comes to highlighting the justification for prohibiting *gharar* in Islam. Some of these studies successfully highlight how excluding *gharar* from contracts will promote fairness and co-operative relations among market participants. In addition,

21 Obaidullah, Mohammah (2000), Regulation of Stock Market in an Islamic Economy. Paper presented in the Fourth International Conference on Islamic Economic & Banking: Islamic Finance: Challenges & Opportunities in the Twenty- First Century, August 13-15, 2000, Loughborough University, UK. , p. 266.

they also mention how the involvement of *gharar* in contracts encourages hate, enmity, competitive relations and volatility in stock markets.

Al-Suwailem's suggested approach, suggests that once a participant is aware that the outcome of a particular exchange is limited to "win-lose", such a participant will be involved with *gharar*. The problem with Al-Suwailem's approach, besides what is mentioned by El-Gamal, is that it is not comprehensive enough to enable the trader to distinguish *halal* from *haram* stocks. Al-Suwailem did not enter into the particularities of stock investing and the basic aspects of stock investing were not tackled. For instance, the author did not discuss the different types of stock valuation, or explain how a Muslim can benefit from conventional tactics for the purpose of *gharar* reduction. In addition, the author did not suggest any stock investing strategies that Muslims can use for the purpose of *gharar* reduction.

Additionally, the two different attempts suggested by Al-Suwailem and El-Gamal at defining and justifying *gharar* can both be regarded as theoretical and impractical when it comes to reality. It is complicated for an average Muslim investor, in advance of investing in a stock, to apply these two approaches. For instance, how can an investor clarify that the outcome of investing in a particular stock is a "zero-sum" game, as suggested by Al-Suwailem. The same problem occurs in El-Gamal's approach: how can an average Muslim investor apply the "cost-benefit" analysis in advance of investing in each stock?

With regards to Obaidullah's approach, the author faces the same criticisms that have already been directed to Al-Suwailem's model, especially because Obaidullah's approach (as he states) is very much based on Al-Suwailem's model. However, Obaidullah was able to distinguish between two types of participants in the stock market: "speculators" and "value investors". This thesis argues that speculators are involved in *gharar*, however value investors are not involved in *gharar*.

The remaining studies e.g. Chapra, Naughton and Naughton and even Obaidullah, attempt to solve the dilemma of *gharar* by highlighting the role of the stock market regulators. Hence, the stock market regulators are obliged to set a number of rules for the purpose of limiting *gharar* in stock investing. For example, banning stock market participants from trading on a margin account basis, or setting price limits on daily basis.

The researcher of this thesis believes that if *gharar* is defined narrowly in terms of deception in financial transactions, then the existing stock market regulatory practices outlawing fraud, insider trading, disclosure requirements and other similar regulations will adequately guard against it. However, in this dissertation a broader view of *gharar* is explored. In this thesis, *gharar* is not taken to be confined to deception and thus, whilst the strict regulatory stance on fraud, insider trading and disclosure requirements guards against one aspect of *gharar*, it does not eliminate all aspects. Nor does this thesis follow the view that speculation and risk-taking is acceptable provided it has no impact on any one also but the speculator himself. Apart from the potential unlawfulness of ensuring this is the case of Muslims do have a responsible for their behaviours according to the *shariaa* law even if there are no consequences on others.

1.3 Current Study

It can be observed that none of these studies defined *gharar* in terms of stock investing, despite the significance of this topic for stock investing. The significance of *gharar* in terms of stock investing is based on two issues. First, as *riba* is prohibited in Islam and makes a financial contract null and void, the same is for the case of *gharar*. Second, the phenomenon of stock investing in the Muslim world is widespread. A recent study revealed that Muslim wealth is estimated to reach 1.2 trillion dollars by 2003[22], and it is argued that a significant percentage of this is invested in Western firms such as Microsoft, Mercedes Benz, Boeing and British Airways. In the meantime, the discipline of stock investing from an Islamic perspective is immature; noting that contemporary Muslim scholars have only recently started emphasising this topic.

Having said that, it is felt that there is a necessity to increase Muslims' understanding of *gharar* in terms of stock investing. Consequently, when these investors tend to invest in stocks they will at least attempt to indicate and so avoid *gharar*. In addition, it is hoped that the issue of *gharar* will also be considered in the screening criteria of Islamic Equity Funds and Indexes.

This thesis, therefore, addresses the following questions:

1- How can *gharar* be defined in the context of stock investing?
2- How can *gharar* be reduced in stock investing?
3- What are the strategies (overall approaches to investments) that Muslims are able to pursue to avoid being trapped in *gharar*?
4- Are there particular tactics (specific investment methods) that Muslim investors are able to undertake before investing in a particular stock, especially when it comes to assessing risk?

22 Merrill Lynch/Gemini Consulting (1999), World Wealth Report 1999, available at: http://www.ml.com/about_ml.htm, Internet, last accessed at 12/12/2000.

5- How can Muslims benefit from the contemporary theories and approaches such as Modern Portfolio Theory and Value Investing Approach, in the sense of reducing *gharar*?

In conclusion, the aim of this thesis is suggesting a framework, within the Islamic tradition, for identifying and reducing *gharar* in the case of stock investing. This work will critically assess and evaluate modern Islamic scholarly interpretations regarding investing in stocks and equity funds. It is hoped that this thesis will increase our understanding of the topic of *gharar* in terms of stock investing.

The original work of the thesis can be summarised in the following three major points:

I. An analysis of the different sources of Islamic contract law to define *gharar* in the context of stock investing,

II. a survey of Islamic Equity Funds and Indexes to verify whether or not the current screening criteria take account of *gharar*, and

III. the development of investment strategies and / or a screening criteria which do take account of *gharar*.

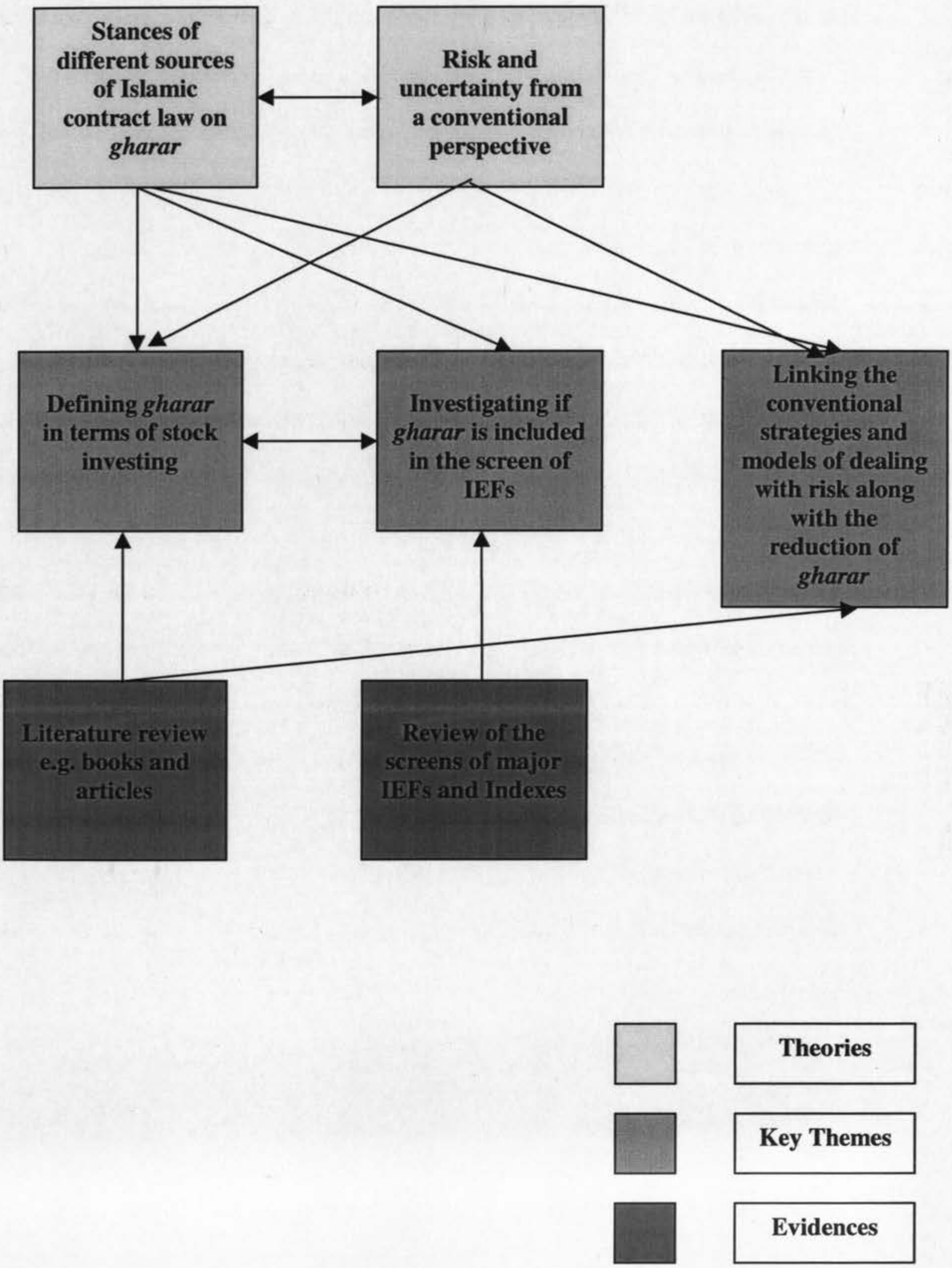
1.4 Conceptual Framework

This study does not adopt a deductive, hypothesis testing approach. The chart (1.1) elaborately shows the key themes at the centre with the background theories[23]and empirical evidences feeding into the key themes. In addition, the author of the thesis, as a Muslim, believes that the Quran with no doubt is the word of God. Consequently, all verses derived from the Quran are to be treated as facts, without question. It is worth indicating that I have no intention to come up with a new *fatwa* or *ijtihad* (formal legal opinion). I intend to conduct a rational assessment of modern screening criteria of Islamic Equity Funds in the light of the flexibility and elasticity of Islamic law, and to explore the possibility that *gharar* - in terms of stock investing -can be accommodated with Islamic principles. It is not my intention to get into the details of the debate of the four *fiqh* Islamic schools.

The suggested conceptual framework covers the main features of the thesis in addition to their proposed relationships. This framework comprises of the following three main elements: theories, key themes, and evidences. The literature review is taken to be the theories that are used to help identify, define and understand the definition of *gharar* in terms of stock investing; the key themes that are relevant in the particular context being investigated; and the evidences being used to shed further light on the key themes. The links and relations between these three aspects are summarised in Chart (1.1). The purpose of the chart is to capture the major relationships among the major different elements of the thesis. This ultimately increases our understanding of the thesis structure.

23 When it comes to highlighting the stances of different sources of Islamic contract law on any particular issue, Muslims regard these theories as "concepts" or principles", sense they are derived from the Islamic law.

Chart (1.1)
Conceptual Framework



Consistent with the key themes of the thesis, the method of research applied is purely based on qualitative analysis. Patton asserts that qualitative methods or analysis permit the researcher to study selected issues in depth and details, and the data collection process is not constrained by predetermined categories of analysis. [24] In this thesis, the researcher attempts to connect the key themes and major aspects of the thesis in an internal consistency and a coherent logic, across the thesis components, including its sampling.

The thesis relies on different types of secondary sources of information. The thesis extensively interprets, presents the findings, and analyses the data derived from scholarly writings on the topic of *gharar*, which can be found in journal articles, books (both historical and contemporary) and several conference papers. While talking about qualitative analysis, Patton mentions the following:

> Description and quotation are the essential ingredients of qualitative inquiry. Sufficient description and direct quotations should be included to allow the reader to enter into the situation and thought of the people represented in the report .... [25]

Punch asserts that "very often, the point of a qualitative study is to look at something holistically and comprehensively, to study it in its complexity, and understand it in its context." [26] The thesis attempts to look at *gharar* comprehensively, and study its complexity, and attempts to understand it in the context of stock investing. Punch also mentions:

> It is important for the qualitative researcher to be able to convey the full picture. There are two parts of this idea. First, the description (of the group, or the case, event or phenomena) must specify everything a reader needs to know in order to understand the findings. Second, the research report needs to provide sufficient information about the context of the

24 Patton, Michael (1990), Qualitative Evaluation and Research Methods, 2nd ed., SAGE Publications, Inc., p.165.

25 Ibid., p.430.

26 Punch, Keith (1998), Introduction to Social Research, SAGE Publications, p. 192.

> research so that a reader can judge the transferability or generalization of it findings. [27]

In order to be able to solve the dilemma of *gharar* in stock investing, it is necessary first to provide a full picture of *gharar*, and this requires clarifying how the different sources of Islamic contract law defined and described this important topic. In light that *gharar* is related to risk and uncertainty, the thesis refers back to different types of Western literature. In addition, the thesis, in several instances, refers to contemporary Western literature related to the different conventional models, methods and strategies of dealing with risk.

The thesis provides the required source of evidence to verify if *gharar* has been included in the screening criteria of Islamic Equity Funds and Indexes. This requires selecting a sample of screens. Patton mentions the following:

> Perhaps nothing better captures the difference between quantitative and qualitative methods than the different logics that undergird sampling approaches. Qualitative inquiry typically focuses in depth on relatively small samples, even single cases (n=1), selected purposefully. Quantitative methods typically depend on larger samples selected randomly. Not only are the techniques for sampling different, but the very logic of each approach is unique because the purpose of each strategy is different. [28]

As shown in chart (1.1), the thesis attempts to explore three main key themes. The following lines identify these themes. In addition, these lines clarify the relationship between the key themes, theories, and evidences.

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27 Punch, Keith (1998), Introduction to Social Research, SAGE Publications, p. 192.

28 Patton, Michael (1990), Qualitative Evaluation and Research Methods, 2nd ed., SAGE Publications, Inc., p.169.

The first key theme is defining *gharar* in the context of stock investing. Coming up with a clear definition of *gharar* in terms of stock investing is associated with some difficulty since *gharar*, in terms of stock investing, has still not be defined by scholars. Therefore, while defining *gharar* in terms of stock investing, it is essential to refer back to the way the different sources of Islamic contract law explained *gharar*. The problem is that these sources defined and explained *gharar* differently. The thesis attempts to analyse the different interpretations and then find the commonalties among them in order to solve the dilemma of *gharar* in stock investing. The main sources that the thesis refers to in order to achieve the first key theme are: Al-Zarqa (1967-1968), Ibn Qayyim al-Jawziyya (1973), Ibn Rushd (1981), Al-Darir (1997), El-Gamal (2001), Al-Suwailem (1999), Vogel and Hayes (1998), Saleh (1992).

The second key theme is investigating if *gharar* is included in the screening criteria of Islamic Equity Funds and Indexes. For this purpose, the source of evidence presented by the thesis is a sample of screens. These screens are derived from both Islamic Equity Funds and all Islamic Equity Indexes. There are several reasons behind selecting only a "sample" of screens, the following lines clarifies these reasons. First, there is an increasing number of IEFs that do not clearly specify in their "prospectus" the screening criteria they apply. This is especially the case in most of those IEFs promoted in Muslim countries, noting that the laws of most these countries do not force the fund promoters and managers to issue a prospectus. Secondly, for the last five years, the trend among IEFs is towards having similar screening criteria. The reason for this might be because the screening criteria of IEFs are set up by the same people who are members of the *Shariaa* Supervisory Boards (SSBs) of IEFs. Third, it can be argued that focusing on the screening criteria of Islamic Equity Indexes is, to a certain extent, satisfactory. This takes into consideration that these indexes are set up and promoted by very reputable firms around the world e.g. Dow Jones and Financial Times. Finally, it is argued that the size of the sample is supposed to reflect the purposes of the thesis. Punch asserts that the sampling strategies vary considerably from one study to another, and the central issue is that these strategies reflect the purposes and questions guiding of the study. [29] Patton mentions that there are "no rules" for sample size in qualitative inquiry, it all depends on what the researcher tends to know, the purpose of the inquiry, what's at stake, what will be useful, what will have credibility, and what can be done with available time and resources. [30] Miles and Huberman suggest a number of questions that help the researcher in selecting the proper sampling strategy; the following are two of these suggested questions:

> - Is the sampling relevant to your conceptual frame and research questions?
> - Does your plan enhance generalizability of your findings, through either conceptual power or representativeness? [31]

According to Patton, there are two sampling strategies. The first is Random Probability Sampling; the purpose behind this strategy is selecting a "representative" sample size of the population and desired confidence level. The second sampling strategy is Purposeful Sampling; the purpose behind this strategy is looking for "information-rich" cases, from which one can learn a great deal about issues of central importance to the purpose of the research. Table (1.1) summarises the different Sampling Strategies and the different types of each strategy. [32]

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29 Punch, Keith (1998), Introduction to Social Research, SAGE Publications, p. 193.

30 Patton, Michael (1990), Qualitative evaluation and research methods, 2nd ed., SAGE Publications, Inc., pp.184-185.

31 Miles, M.B. and Huberman, A.M. (1994), Qualitative Data Analysis. 2nd edition, Thousands Oaks, CA-USA., p. 34.

32 Patton, Michael (1990), Qualitative evaluation and research methods, 2nd ed., SAGE Publications, Inc., p.184.

Table (1.1)
Sampling strategies[33]

Type	Purpose
A. Random probability sampling	Representatives: Sample size a function of population size and desired confidence level.
1. simple random sample	Permits generalisation from sample to the population it represents.
2. stratified random and cluster samples	Increases confidence in making generalisations to particular subgroups or areas.
B. Purposeful sampling	Selects information-rich cases for in-depth study. Size and specific cases depend on study purpose.
1. extreme or deviant case sampling	Learning from highly unusual manifestations of the phenomenon of interest, such as outstanding successes …
2. intensity sampling	Information-rich cases that manifest the phenomenon intensely, but not extremely, such as good students/poor students,…
3. maximum variation sampling	Documents unique or diverse variations that have emerged in adapting to different conditions. Identifies to different conditions. Identifies important common patterns that cut cross.
4. homogenous sampling	Focuses, reduces variation, simplifies analysis, facilitates group interviewing.
5. typical case sampling	Illustrates or highlights what is typical, normal, average.
6. stratified purposeful sampling	Illustrates characteristics of particular subgroups of interest; facilitates comparisons.
7. critical case sampling	Permits logical generalisation and maximum application of information to other cases because it's true of this one case it's likely to be true of all other cases.
8. snowball or chain sampling	Identifies cases of interest from people who know people who know people who know what cases are information rich, that is, good examples for study, good interview subjects.
9. criterion sampling	Picking all cases that meet some criterion, such as all children abused in a treatment facility. Quality assurance.
10. theory-based or operational construct sampling	Finding manifestations of a theoretical construct of interest so as to elaborate and examine the construct.
11. confirming and disconfirming cases	Elaborating and deeping initial analysis, seeking exceptions, testing variations.
12. opportunistic sampling	Following new leads during fieldwork, taking advantage of the unexpected, flexibility.
13. random purposeful sampling (still small sample size)	Adds credibility to sample when potential purposeful sample is larger that one can handle. Reduces judgement with in a purposeful category.
14. sampling political important cases	Attracts attention to the study (or avoids attracting undesired attention by purposefully eliminating from the sample politically sensitive cases.
15. convenience sampling	Saves time, money and effort …
16. combination of a mixed purposeful sampling	Triangulation, flexibility, meets multiple interests and needs.

33 Patton, Michael (1990), Qualitative Evaluation and Research Methods, 2nd ed., SAGE Publications, Inc., p.184.

Among these latter different strategies, the thesis selects the strategy called Critical Case Sampling (CCS), which is one of the types of Purposeful Sampling Strategy. Patton mentions that CCS focuses on samples that can make a point dramatically or are, for some reason, particularly important in the scheme of things. For this purpose, part of the sample is all Islamic Equity Indexes, noting that the screens of these indexes are viewed as a "screening benchmark" by fund managers of Islamic Equity Funds. Patton mentions that "a clue to the existence of a critical case is a statement to the effect that 'if it happens there, it will happen anywhere,' or, vice versa, 'if it doesn't happen there, it won't happen anywhere.' [34] It is believed that the sample employed by the thesis achieves the ultimate concern of this key theme, which is identifying if *gharar* is included in the screens of Islamic Equity Funds and Indexes.

Investigating the screening criteria of IEFs and Indexes can also, beside the latter key theme, achieve the following purposes. First, to clarify the methodology employed by fund managers for differentiating between permissible stocks from non-permissible ones. Second, to determine Muslim investors' style in stock investing. Third, to highlight the major aspects which these screening criteria focus upon.

The last and third key theme is an attempt to link the conventional strategies and models of dealing with risk, along with the reduction of *gharar*. This theme is divided to the following two parts. The first part attempts to clarify the general strategies of dealing with risk. After reviewing the general strategies, each one will be analysed from an Islamic perspective, in order to indicate which of these strategies

34 Patton, Michael (1990), Qualitative Evaluation and Research Methods, 2nd ed., SAGE Publications, Inc., p.174.

might be appropriate for Muslims to employ for the purpose of *gharar* reduction. Note that it may not be possible to eliminate *gharar* entirely. Any investment involves risk, a major question is when this risk becomes excessive and what tactics might be employed to eliminate significant unnecessary outcomes. *Gharar* is not here confined to the deliberate creation of risk, though, for example speculation or gambling, which might damage other people.

The second part of the latter third key theme is to demonstrate the different stock valuation models of dealing with risk. The thesis focuses on three models: Modern Portfolio Theory, Value Investing and conventional derivatives. These three models will be analysed from an Islamic perspective, in order to decide on which tactics and ratios derived from these models can be employed for *gharar* reduction. It should be mentioned that the Islamic literature on this subject is scanty, however, sufficient information can be found in the Western literature. The following are the main books that the thesis refers to for achieving the third key theme: Graham and Benjamin (1934), Hagstrom (1994), Fischer (1995), Malkiel (1995), Brandes (1997), Siegel (1998). Cohen (1998), and Damodarn (2001).

1.5 Plan of the Thesis

The rest of this thesis is divided into three parts. The first part consists of chapter (2) titled "Framework of Islamic Finance", and chapter (3) titled "Setting of Islamic Banking". The purpose of these two chapters is providing a basic introduction to the subject of Islamic banking and finance. Several basic terminologies in the practice and theory of Islamic finance are explained in this part. Also several controversial issues in the practice of Islamic banking are explored in these two chapters. This part also explores the prohibition of *riba* (usury) in Islam and then investigates the alternative of *riba*-based financing. The role of *Shariaa* Supervisory Boards is also highlighted. The last section of this part tackles the affect of globalisation on Islamic banking.

The second part consists of chapters (4) and (5). The former chapter is titled "The Question of *Gharar*". The purpose behind this chapter is solving the dilemma of *gharar* in the context of stock investing. The chapter highlights the stance of the different sources of Islamic contract law on the issue of *gharar*. Both terms Risk and Uncertainty are defined from a Western perspective, and this is in light of the importance of these two terms in the definition of *gharar*. The last part of this chapter attempts to establish a relation between both high speculation and gambling and the thesis suggested definition of *gharar*. Chapter (5) is called "Screening Criteria of Islamic Equity Funds and Indexes". In this chapter the screening criteria of Islamic Equity Funds and Indexes are investigated in order to determine if *gharar* is included or not.

The third part consists of chapters (6), (7) and (8). Chapter (6) is called "Strategies for Managing Risk Resulting from *Gharar*". The purpose of this chapter is to decide on the strategies that Muslim investors are able to employ for the purpose of reducing *gharar*. Chapter (7) is titled "Conventional Stock Valuation Models". This chapter is regarded as an introductory chapter for the last chapter of the thesis. The purpose of chapter (7) is limited to clarifying the different stock valuation models. Chapter (8) is titled "Building an Approach for Managing *Gharar*". This chapter analyses the different conventional stock valuation models from an Islamic perspective and attempts to decide on a number of ratios and tactics for the purpose of reducing *gharar* in the context of stock investing.

CHAPTER 2

FRAMEWORK OF ISLAMIC FINANCE

2.1 Overview

The purpose of this chapter is to identify the fundamental aspects of Islamic finance and banking. The chapter is divided into three parts. The first part highlights the prohibition of *riba* (usury) in Islam. The second part clarifies the Islamic alternative to usury-based financing, and how this alternative differs from usury-based financing. Also in this part, the major Islamic financial modes are identified. The last part of this chapter sheds light on the *Shariaa* Supervisory Boards. The importance of this part emerges from the critical role these *Shariaa* Supervisory Boards are supposed to play.

2.2 *Riba* in Islam

2.2.1 Introduction

The Economist magazine in an article titled "Usury: The lender's long lament" mentions the following:

> Usury - which once meant nothing more than lending money in return for Interest - has always attracted the attention of lawmakers and theologians. Three of the world's great religions have formal prohibitions against it, even though these have not always been followed strictly. The arguments against interest come down essentially to two: lenders are, in effect, getting something for nothing; and a man should help his neighbor without hope of gain. Such was the contempt for usury in the late Middle Ages that modern banking might have been strangled at birth[1]

"Usury" is defined as "the lending of money with an interest charge for its use"[2]. Usury lending has been practiced in various parts of the world for at least four thousand years.[3] During this period, there has been substantial criticism mainly from the social reformists and the different religions. The three major religions of Christianity, Judaism and Islam all have formal prohibitions against usury. In the case of Christianity, the church's simplest and earliest objection to usury was based on that it consisted of "unearned income".[4] It is worth mentioning that from these three religions, Islam was the only one seriously to employ the prohibition of usury in modern life. One of the major tenets of Islamic banking and finance is that all financial services must be free of *riba*. In other words, Islamic banks do not receive or charge interest on any of the provided financial services, and that is due to the prohibition of *riba* (usury).

1 The Economist (1993), Usury: The Lender's Long Lament, , Dec 25, Vol. 329, Issue. 7843, p. 103.

2 Merriam-Webster on line Dictionary, available at: http://www.m-w.com/cgi-bin/dictionary, Internet, last accessed at 29/04/2001.

3 A.M., Wayne and McIntosh Alastairs (1998), A Short Review of the Historical Critique of Usury, available at: www.AlastairMcIntosh.com, Internet, last accessed at 03/05/2001, p.1.

4 Ibid, p.8.

Riba in the pre-Islamic era literally translated as excess, expansion addition, or growth, referred to the practice of lending. At that time, debtors had to pay a fixed amount above the principal borrowed from lenders for the use of the money. This additional amount, which depended on the predetermined rate, was called *al-riba*. There is an extensive literature[5] on the topic of *riba*; aware that most (if not all) of this literature follows a similar approach; it tends to focus on how usury is regarded as an evil activity in Islam. Nevertheless, most literature does not concentrate on the several advantages resulting from employing contemporary interest-rate based transactions. This part of thesis tends to focus on this latter issue.

Several contemporary Western writers[6] promote the so-called "Economic Value Added" approach (EVA), which is defined as a financial performance measure designed to determine the "true economic profit" of a firm. EVA is also directly linked to the creation of shareholder wealth over time.[7] The EVA is calculated as follows:

EVA = (Return on Capital - Cost of Capital) / (Capital Invested in Project)[8]

In particular aspects, this approach is becoming a milestone in both the modern theory of corporate finance and investment management. In regard to corporate finance, the EVA emphasizes on the present value relationship between a firm's "expected EVA" and its current net present value (NPV), as well as the financial characteristics of wealth-creating firms, industries, and economies. Emphasis in investment management is placed on how

5 See Saleh and Ajaj (1992), Saeed (1997), Vogel and Hayes (1998), Rida (2001), and Rafiq (2000).

6 See Stewart (1991), Young & others (2000), Stern & others (2001), and Grant (1997).

7 Stern Stewart web site, available at: http://www.sternstewart.com/evaabout/whatis.shtml, Internet, last accessed 03/05/2001.

8 According to Professor Damordoran, New York University. Available at: http://www.stern.nyu.edu/~adamodar/New_Home_Page/lectures/eva.html, Internet, last accessed 03/05/2001.

to apply EVA principles to select equity securities, and to build investment opportunities in the context of the Modern Portfolio Theory (MPT) portfolio model.[9]

Stewart[10] is one of the authors who has played a primary role in developing EVA theory. In his book "The Quest for Value", the author identifies the advantages that a firm gains by increasing the use of debt, what the author means by "interest based debt". Stewart asserts that in the case of the USA, the aggressive use of debt has, on balance, been a positive force in the sense that is served as a catalyst for many U.S firms to increase their "productivity" and "market value". The author suggests the following five advantages resulting from aggressive use of debt. First, the obligation to pay back the debt eliminates the "irresistible temptation" to over invest surplus cash flow in "unworthy" business or make highly priced acquisitions. Secondly, through debt, the firm is able to deduct taxes because the charged interest is computed as an expense and this ultimately reduces the firm's net profits. For this reason, debt is a less "expensive" type of financing than equity. Thirdly, using debt in an aggressive manner presents an opportunity for individuals, e.g. managers and employees to increase their ownership in their firm, and this will ultimately affect the value of the firm in a positive manner. Fourthly, the desire to reduce and repay the debt on a frequent basis encourages the firm's management to sell any non-performing assets or business lines, and this particularly occurs when there is a competitor firm in the market that is more capable of managing the acquired business. In this case, a profitable trade can be arranged in which the buyer pays the seller a "large part (if not all)" of the value's asset, and through the value resulting from the trade, the

9 See Grant, James (1997), Foundations of Economic Value-Added, McGraw-Hill Professional Publishing, USA.

10 See Stewart, Bennett (1991), The Quest for Value: The Eva Tm Management Guide, Harper Business, USA.

buyer is expected to create tangible reward by finding a better business "fit". The last reason is mostly psychological. Debt creates an illustration of financial "distress", even for what may be a fundamentally healthy business, and thereby "precipitates painful" but "necessary" changes. [11]

Despite all these advantages, firms that operate according to the basic tenets of Islamic law are strictly banned from dealing with interest-rate based transactions. For instance, God in the Quran describes those who deal with usury as people who "cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch."[12] In addition the Prophet clearly states that "to eat up Riba (usury)"[13] is regarded as one of the "great destructive sins". In this context, two important questions emerge; what is the rationale of banning usury or *riba* in Islam? Secondly, is there an alternative i.e. any other financing modes that (1) are compliant with the different sources of Islamic contract law and (2) fulfill the same purpose in which interest-rate based debt is currently serving?

11 See Stewart, Bennett (1991), The Quest for Value: The Eva Tm Management Guide, Harper Business, USA.

12 The Quran: al-Baqarah [2:275.4].

13 Sahih Bukhari, Vol. 4, Book 51, No. 28.

2.2.2 Basics of *Riba* in Islam

There is no dispute among Muslim scholars and jurists that *riba* is prohibited, but there are subtle differences in interpretation. It is important to indicate from the beginning, that most Muslim scholars agree that Islamic law does not deny the "time value" of money, but they take pains to distinguish between the "interest- rate" on a loan for a "fixed period" of time and the projected "uncertain rate" of return that a person might hope to achieve by position this capital in a business for a given period of time.[14]

There are two forms of *riba* : (1) *riba al-fadl*: in this case, money is exchanged for money hand-to-hand, but in different quantities, or (2) *riba al-nasia*: where money is exchanged for money with delay. The following is a well-know *hadith* on *riba*:

> Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, and salt by salt, like for like and equal for equal, payment being made hand to hand. If these classes differ, then sell as you wish if payment is made hand to hand.[15]

This *hadith* indicates that certain goods, usually described as "*riba* related" goods, can be bartered for each other on present basis "hand to hand". Hence, all exchanges with delay among the previously listed six goods, with or without equality or identity of type follow under what is called (*riba al-nasia*). In the same context, exchange of goods in a single type is strictly permitted to equal amounts, alternatively, this is called *riba al-fadl,* which in this case, a good is exchanged for a similar hand-to-hand, but in different quantities. The following *hadith* illustrates more on the issue of spot sales and the case of *riba*.

> I came saying who was prepared to exchange dirhams (for my gold), whereupon Talha b. Ubaidullah ... said: Show us your gold and then come to us (at a later

14 Vogel, Frank, and Hayes, Samual (1998), Islamic Law and Finance: Religion, Risk, and Return, Kluwer Law International, Massachusetts--USA., p. .202.

15 Sahih Muslim, Book 010, No. 3853.

> time). When our servant would come we would give you your silver (dirhams due to you). Thereupon 'Umar b. al-Khattib (Allah be pleased with him) said: Not at all. By Allah, either give him his silver (coins). or return his gold to him, for Allah's Messenger (may peace be upon him) said: Exchange of silver for gold (has an element of) interest in it except when (it is exchanged) on the spot; and wheat for wheat is an interest unless both are handed over on the spot: barley for barley is interest unless both are handed over on the spot; dates for dates is interest unless both are handed over on the Spot. [16]

The question that follows "is it lawful to exchange less amount of high quality of wheat with higher amount of lower quality"? In order to avoid being trapped in *riba al-fadl*, the exchange of the gold must be in similar types and in equal amounts, however, in other *hadith*, the Prophet permits Muslims to perform the latter exchange via a means of exchange i.e. money. In other words, the exchange is permissible once one of the parties sells his gold to obtain cash and then buys the other's gold with the cash. The subsequent question is: are the rules of *riba* mentioned by the Prophet only relevant to *riba*- related goods? The majority of *fiqh* schools agree that the *riba* rules are not limited to *riba*-related goods. Furthermore, the scholars employ "analogy" in order to come up with efficient causes for the *riba* prohibition rules mentioned by the Prophet. The definition of the "efficient causes" differs from one school to other, Vogel and Hayes assert that:

> The Shafi's detect two causes among the six cases of the *hadith*: currency and food. The Malikis add to food additional traits: being basic foodstuff and being preservable. Hanafi and Hanabli schools see only one cause – good sold by either weight or volume. [17]

Thus far, the two previously mentioned *hadiths* do not directly touch up on the existing type of *usury*, which is the basic tenet of the existing Western financial system. In this case, most scholars refer to the following *hadith*[18]: "Every loan [*qard*] that attracts a

16 Sahih Muslim, Book 010, No. 3850.

17 Vogel, Frank, Hayes, Samual (1998), Islamic Law and Finance: Religion, Risk, and Return, Kluwer Law International, Massachusetts-USA. p. 75.

18 Vogel and Hayes (1998) cite that this hadith is not related to the Prophet, but related to respected scholars only on the authority of Companions.

benefit is *riba*"[19]. Scholars classify interest charged on loans as a "benefit" for the loan provider. This *hadith* is used by Muslims scholars as a justification for the prohibition of dealing with interest-rate based transactions. The other justification of usury prohibition in Islam can be analyzed from an ethical perspective. The following lines attempt to shed some light on the ethical dimension e.g. injustice and unfairness, as a raison d'être of usury prohibition.

One of the functions of commercial banks is providing loans and other finance techniques to either individual or corporate customers. Extending to customers different types of credit; including diverse loans and credit accounts is what traditionally makes banks profitable. These profits are a result of charging the borrowers interest fees in excess of what the bank pays back to the depositors, in this case, the bank acts as a intermediary between those who have access of funds and others who lack funds. These banks penalize borrowers who delay paying their installments on time, the penalty takes place as an increase in the charged interest-rate. This penalty is regarded as a way of putting pressure and some times punishing the bank's customers. In Islam, this way of treating troubled customers is considered "unfair", because the bank is benefiting from the financial weakness of the borrower, and that is especially when the customer stops the progress of paying the required installments due to "out of control" circumstances. The following two *hadiths* illustrate more on this issue.

> The Prophet said, "There was a merchant who used to lend the people, and whenever his debtor was in straitened circumstances, he would say to his employees, 'Forgive him so that Allah may forgive us.' So, Allah forgave him.[20]

19 Al-Shawkani, Ali (d.1839), Nayl al-awtar, Mustafa Babi al-Halabi, n.d., Vol. 5, Cairo,.p.262.

20 Sahih Bukhari, Vol.3, Book 34, N o. 292.

Narrated 'Aisha:

> When the last Verses of Surat-al-Baqara were revealed, the Prophet read them in the Mosque and prohibited the trade of alcoholic liquors. "If the debtor is in difficulty, grant him time till it is easy for him to repay[21]

A "default risk" is a common type of risk faced by financial institutions. This type of risk materializes when the borrower stops paying the required loan plus any interest amounts. In order for the bank to minimize this risk, it tends to assure that all provided loans and other credit facilities must be restricted to those customers with financial ability to pay. As for those customers without property or enough financial sources, they are unable to access to any funds. According to The Economist:

> Formal, officially regulated, lenders will not lend to many would-be borrowers--notably the poor, who can offer little in the way of security. It cannot be better that these people should be denied credit altogether than that they should be able to borrow at interest, however "exorbitant", if they choose. Discomfort at this thought has something to do with the outright criminality of some moneylenders' behaviors—but that explanation goes only so far. Something of the distaste for lending at interest that all societies felt in the past, and that many societies (notably Islamic ones) still feel, persists in the West.[22]

Islam treats all levels of the society in an indistinguishable manner especially when it comes to discriminating between the rich and the poor. Indeed, as this following verse indicates, the rich have a duty to give to charity instead of exploiting the deprived person. The verse indicates the following:

> That which ye give in usury in order that it may increase on (other) people's property hath no increase with Allah; but that which ye give in charity, seeking Allah's Countenance, hath increase manifold. [23]

21 Sahih Bukhari,Vol. 6, Book 60, No. 66.

22 The Economist (1993), Usury: The Lender's Long Lament, Dec 25, Vol. 329, Issue. 7843, p. 103.

23 Al Quran: ar-Rum [30:39.6].

Islam attempts to sustain the task of money or currency and refer it back it to its original purpose i.e. money is a neutral measure of value. Ibn Qayyim [24] was one of the first to bring up this issue. Money must not be traded as any other commodity and should be with drawn from commerce. However, Islam left the door open to generating profits and gains from different *halal* manners. The most important issue is that these gains and profits must be morally justified when one faces to secure it. Gain not accompanied with any sort of risks is prohibited in Islam. Accordingly, Muslims are banned from investing in governmental T-bills, simply because there must be a risk to justify any return or profit. Now, this issue leads to one of basic tenets of Islamic finance and banking, which confirms that the lender (usually the bank) is obliged to share the risk with the borrower. Again justice and fairness must accompany all financial contracts. The bank or the financier is obliged to participate in sharing the risk with the customer, and as long as the business continues to exist, both parties must share the risks as well as the profits and losses. This lead us to the next section, which provides an overview on the alternative to usury-based financing.

24 See Ibn Qayyim al-Jawziyya, Muhammad bin Bakr (1973), I'lam al-muwaqq'in'ala rabb al-'alamin. Edited by Taha 'Abd al-Ra'uf Sa'd. (d.751/1350), Dar al-jil, Beirut.

2.3 The Islamic Alternative to Usury-Financing

One of the possible ways of dividing the Islamic financial modes is as follows: (1) debt creating modes of financing and (2) non-debt creating modes of financing. [25] The former type includes: - *murabaha*, *bai muazzal*, *ijara*, *salam*, and *qard hassan*. The common issue between these instruments is that the beneficiary is either committed to pay back the borrowed funds, and most important with no interest such as in the case of *murabaha*, *bai muazzal* and *qard hassan*. Or the beneficiary is committed to pay for the use of the service or commodity through installments such as in the case *ijara*. Nonetheless, the beneficiaries of funds in the case of non-debt creating modes are not required to repay the total amount of funding; instead the involved parties share the gains (and some times the loss) under a predetermined formula. The modes under this category include *mudaraba* and *musharaka*.

There are several books that discuss the different Islamic financial modes, for example: Moore (1997), Vogel and Hayes (1998), Haron and Shanmugan (1997), Siddiqi (1985), and Saleh (1986). Thus, the focus in this part of the chapter is limited to highlighting the major Islamic financial modes. These modes include: *mudaraba* and *musharaka*; both are regarded as the core and foundation of Islamic finance theory. The third mode is *murabaha*, since it is by far the most widely practiced mode by the Islamic banks. In addition a short overview will be given of *salam*, *istisna*, and *ijara*. While describing these central modes, an attempt is made to clarify the justification of permitting these

25 Haron, Sudin, Shanmugan, Bala (1997), Islamic Banking System Concepts and Applications, Pelanduk Publications, p. 112.

modes in Islam, and how these modes tend to vary from usury-based modes. Noting that some of the Islamic financial modes share very similar characteristics with usury-based modes, however these Islamic ones carry different labels. As previously indicated, one of the central reasons behind banning usury-based instruments in Islam, is due to unethical and injustice concerns. Accordingly, the critical question is: do these Islamic financial modes solve the ethical and justice dilemma? In other words, are all of the Islamic financial modes based on ethical and justice concerns?

2.3.1 *Murabaha*

Murabaha is defined as the sale of an asset for the price at which the seller has acquired it plus a predetermined percentage of profit. The cost and the profit margin must be agreed upon between the buyer and the seller.[26] *Murabaha* is sometimes labeled as "cost-plus-profit" or "mark up sale" or "deferred payment sale". This short-term Islamic financial mode has been the central focus of Islamic banks. It can be argued that one of the reasons that creates high demand for the *murabaha* mode is the nature of the stock market in Islamic countries. These stock markets are regarded as "immature" and "shallow". Consequently, funding for bushiness expansion largely comes from ploughed back profits or family networks.[27] On other hand, there are others who argue that Islamic banks are generating high profits with less risk by offering *murabaha* mode on the account of other central Islamic financial modes.

Despite its wide acceptance among Islamic banks, *murabaha* has been criticized by many jurists especially the conservative. They argue that *murabaha* is similar to an "interest rate based" loan. Beedham, while elaborating on of *murabaha* mode, suggests the following example:

> The Koran says you cannot borrow $100m from the bank for a year, at 5% interest, to buy the new machinery your factory needs? Fine. You get the bank to buy the machinery for you--cost, $100m--and then you buy the stuff from the bank, paying it $105m a year from now. The difference is that the extra $5m is not interest on a loan, which the Koran (perhaps) forbids, but your thanks to the bank for the risk it takes of losing money while it is the owner of the machinery: this is honest trade, okay with the Koran. Since with modern communications the bank's ownership may last about half a second, its risk is not great, but the transaction is pure. It is not surprising that some Muslims uneasily sniff logic-chopping here.[28]

26 Saleh, Nabil (1986), Unlawful Gain and Legitimate Profit in Islamic Law, Cambridge University press, p. 96.

27 Wilson, Rodney (1995), Going Global, The Banker, March, Vol. 15, Issue. 829, London-U.K. pp. 45-46.

28 Beedham, Brian (1994), The Cash-flow of God, The Economist, Aug 6, Vol. 332, Issue 7875, p. 9.

In the same context, Saleh asserts the following:

> The only factor which, in the opinion of the conservative jurists, would probably transform *murabaha* into a legal device (*hila*) used to circumvent the prohibition of taking interest is pricing the time factor. That occurs when, in addition to the initial price of the commodity and other recognised expenses and legitimate profit, an increase is accounted in order to compensate for the delayed payment of the *murabaha* purchase price; otherwise *murabaha* should not, in principle, be under suspicion for it is a universally recognised concept under Islamic law.[29]

A number of *shariaa* scholars, especially those who serve as members of the supervisory boards of Islamic banks, defend *murabaha* by arguing that it is regarded as a "trade" and not as a usury-based financial transaction, and base their argument on the following verse:

> Those who swallow usury cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is just like usury; whereas Allah permitteth trading and forbiddeth usury. He unto whom an admonition from his Lord cometh, and (he) refraineth (in obedience thereto), he shall keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who returneth (to usury) - Such are rightful owners of the Fire. They will abide therein.[30]

In this context, it important to include the risk aspect due to its centrality in Islam. Vogel and Hayes while discussing the issue of *riba*, focus on "*Al-Kharaj bi-al-daman*"[31], which literally means "Gain accompanies liability for loss". One of the interpretations of the latter is that profits and returns are morally justified when there is a "risk" element; otherwise, "risk-less" profits and returns are "unjust".[32] Based on that, one of the ways of questioning the tolerability of *murabaha* is to clarify to what extent Islamic banks are exposed to risk.

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29 Saleh, Nabil(1986), Unlawful gain and Legitimate Profit in Islamic Law, Cambridge University press, p 96.

30 The Quran; al-Baqarah [2:275.25].

31 "Al-Kharaj bi-al-daman." Abu Dawud, Tirmidi, Nasa'I, Ibn Maja.

32 Vogel, Frank and Hayes Samuel (1998), Islamic Law and Finance, Religious, Rrisk, and Return, Kluwer Law International. Massachusetts-USA., p. 83.

Assume that a customer desires a specific type of car, but the lack of financial ability stands as an obstacle in the way of purchasing the car on "cash basis". Assume the customer is happy with *murabaha* mode offered by Islamic banks. Initially, the bank studies the financial ability of the customer in order to confirm that the instalments plus "profit margin" are paid back on time, in other words, the bank attempts to avoid the "default risk". The end result, if the Islamic bank indicates that the customer might be unable to repay the instalments as required, the bank will simply reject the customer's application. So far until this stage, the way the Islamic bank processes the customer's application is exactly the same as in conventional banks. This is despite that (as mentioned previously) one of the main reasons of banning *riba*-financing in Islam is due to ethical matters i.e. the rich (the bank) exploits the poor, and the end results in both cases, Islamic and non Islamic banks, are the same. Islamic bank defenders argue that Islamic banks are not charity providers, these banks are established to generate profits but in a permissible manner.

In the context of latter example, assume that the Islamic bank determined that the customer would be able to repay the instalments "on time". According to *murabaha* contract, the customer purchases the desired car on behalf of the bank for the bank. In most cases thus, the asset does not remain in the ownership of the bank for any significant period. The bank covers itself from any unexpected events by making the customer act as an agent on its behalf, i.e. the customer selects the car of his choice, purchases it on behalf of the bank for the bank, and then instantly, the bank sells back the car to the customer with a profit margin. In short, the degree of risk Islamic banks are exposed to in *murabaha* is almost zero. Consequently, the majority of the Islamic bank's financial transactions are based on *murabaha* mode. Vogel and Hayes clearly condemn the way *murabaha* is practiced by Islamic banks, they state:

> In practice Islamic banks often employ various strategies to reduce their risks in *murabaha* almost to zero, particularly in international trade. In actual deals with have seen, the bank and its customer agree in advance that the second sale (bank sells to customer) occurs at the same instant as the bank gains title under the first sale (supplier sells to bank). Thereby the bank's risk of casualty to the goods becomes infinitesimal. The customer also waives all claims on the banks as seller, such as for beach of warranty or defects in the goods. The bank assigns to the customer its warranty or other rights against the supplier of goods. Usually the bank appoints the customer as its agent to purchase and obtain the goods, reducing any possibility of error as to the goods to be bought and eliminating any burden or costs associated with buying and taking the delivery. [33]

It is worth noting that the approval of the Organisation of the Islamic Conference (OIC) assures that Islamic banks, in the case of *murabaha*, must be exposed to risk in the sense that the goods could be destroyed or harmed, or develop a defect, and that the seller may default. In other words, the bank faces the risk that the buyer will reject the goods as unsatisfactory or defective. [34]

To this extent this chapter tackles *murabaha* mode however there is no intention to issue a legal opinion on any of Islamic finance products. And undeniably, the thesis focus (especially in the first chapters) is limited to imposing critical questions on the table and attempting to tackle them by mentioning the different main stream opinions.

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33 Vogel, Frank, Hayes, Samuel (1998), Islamic law and Finance, Religious, Risk, and Return, Kluwer Law International. Massachusetts-USA., p. 143.

34 Decision 3,2, Fifth Session (1998), Fiqh Academy Journal 2:1599.

2.3.2 *Mudaraba*

Mudaraba is a contract between a minimum of two parties, one of them is the investor (*rab al-mal*) or sometimes called "sleeping partner", the other party is the agent-manager (*mudarib*); sometimes named as the "labour partner". The investor entrusts funds to the agent-manager for the purpose of making business. Both parties are obliged to share the profits according to a pre-determined ratio, and this is after the investor's initial investment amount has been returned from the income generated. The distribution of profits between the two parties must be on a percentage basis and not a lump sum or guaranteed return. In summary, the idea behind *mudaraba* is combining the investors' wealth with the agent manager is expertise, and most importantly this combination is bounded by the basic tenets of Islamic contract law.

In Islamic finance and banking, *mudaraba* is regarded as one of the major alternatives of interest-based finance transactions. Muslim scholars have always given special emphasis to the concept of "risk sharing", or in another words "partnering" the risk resulted from any venture, and that is why *mudaraba* is one of the cornerstones in Islamic finance and banking. Having said that, it is worth indicating that Islamic banks rarely practice *mudaraba* as a financing mode, and instead, focus on the *murabaha* (mark up financing), taking into consideration that Muslim jurists clearly advocate the practicing of *mudaraba* as a financing mode on the account of *murabaha*.

Islamic bankers argue differently. They argue that asserting that Islamic banks do not employ *mudaraba* is false. The justification is that the deposit accounts of Islamic banks are operated on the basis of *mudaraba* contract. In this context, the Islamic bank acts as a *mudarab* (agent manager) on behalf of the depositors' money. To this extent, the Islamic bankers' argument is valid, however the argument is different when it comes to the second part of the process, hence, the Islamic bank as an agent manager link most of the depositors' monies with those individuals and firms that seek short-term financing i.e. *murabaha*. And this is instead of investing these monies in long-term productive projects via *mudaraba*.

There are a number of possible justifications as why Islamic banks are not practicing *mudaraba*. A naive justification is to assume that there are no talented persons with feasible ideas in the Muslim world, therefore Islamic banks have no option other than employing the depositor's money in *murabaha*. A step further, it can be argued that the main objective of Islamic banks is achieving the shareholders' best interests and satisfaction, however in a *halal* manner. This objective can be achieved by focusing on *murabaha* contracts; as a short-term facility with a very limited degree of risk. Therefore, why do Islamic banks bother in entering *mudaraba* which leads to facing moderate to high risk potential risk? In addition, it might take years for the Islamic bank before the initial investment is returned in the case of *mudaraba*. This might be considered a valid argument if it was dedicated to a conventional bank, but certainly not for those banks that hold the phrase "Islamic". The term "Islamic" is certainly much more than only generating permissible profits (as it will be seen later).

Beedham suggests another argument of why Islamic banks are not focusing on *mudaraba* contracts. The author asserts the following:

> The bank may know less about the business in question than the entrepreneur does, so it can be taken for a ride. Moreover, the depositors who in the first place put into the bank the money it invests are also deprived, under this system, of a guaranteed return on their money. They too have to take a risk, which is not much fun if you are an old-age pensioner; and, if this deters them from putting their cash into the bank, there will be less money to invest all round. [35]

It is worth highlighting the ethical and justice dimensions resulting from *mudaraba* contracts. Muslim jurists confirm the importance of directing *mudaraba* and other similar Islamic valid finance modes towards the interests of human welfare.[36] *Mudaraba* provides the opportunity for the party who lacks financial resources to obtain funding and financial support against his feasible ideas and his involvement in the different stages of the potential project. On the other hand, the case is different in the *riba*-based financing. Hence, the same party who lacks financial resources would not get the required funds from conventional banks. Therefore, the *mudaraba* mode opens the door for the different segments of the society; including those underprivileged ones but with potential ideas, to obtain the desired funding. Some might argue that *mudaraba* is very similar to "venture capital", which is widely practiced in most developed Western countries especially the USA. That is right but to a certain extent, because the concept of *mudaraba* in the theory of Islamic finance is very central and it substitutes *riba*-financing. However, in Western economies, *riba*-financing is the central issue and "venture capital" does not substitute for

35 Beedham, Brian (1994), The Cash-flow of God, The Economist, Aug 6, Vol332, Issue 7875, p.11.

36 Siddiqi, Muhammad (1985), Partner and Profit Sharing in Islamic Law, The Islamic foundation, U.K., p.14.

it, but goes along with it. Secondly, in the case of "venture capital", there are no restrictions imposed on the agent-manager with regards to investing in impermissible activities. In the same context, the agent-manager might approach conventional banks for *riba*-based financing. However, both latter two issues are prohibited in the case of *mudaraba*.

The other issue that needs to be tackled in the case of *mudaraba* is risk. The degree of risk in which the involved parties are exposed to in the *mudaraba* contract is certainly above superfluous zero. The contract's nature allows the distribution of risk among all of the parties. As for the investor, the risk refers to the possibility of losing the initial invested capital. This implies that the investor is unable to escape his liability for the loss of his proportion of the total capital. Furthermore, the investor is not responsible of any losses beyond his share of the initial investment.[37] On the other spectrum, the agent manager is exposed to the risk of losing the efforts executed for the sake of the business success. Saleh asserts that:

> *Mudaraba* is necessarily a combination of a measure of business activity conducted according to the customary practice of the merchants and a measure of commercial risk taken by the capitalist.[38]

In addition, the investor is not allowed to prevent the agent manager from performing his normal duties. Conversely, in the event that the investor requires the agent's guarantee against the eventuality that the investment is lost in part or totally, the *mudaraba* contract is null and void.[39]

37 Siddiqi, Muhammad (1985), partner and profit sharing in Islamic law, The Islamic foundation, U.K., p.16.

38 Saleh, Nabil(1986), Unlawful gain and legitimate profit in Islamic law, Cambridge university press, U.K. p.103.

39 Ibid., p.103.

2.3.3 *Musharaka*

After exploring *murabaha* and *mudaraba*, which the former is imperative in the theory of Islamic finance, and the latter is imperative in the practice of Islamic banking, a broader picture is given on *musharaka*. While previously discussing the concept of *mudaraba*, it has been mentioned that it is designed to combine the resources of those with excess of capital along with others that are distinctively skilled but lack financial support. Assuming that there are two parties, the expertise of one of these parties completes the other, and at the same time, both parties have the financial ability to financially back and support a particular venture. In this case, *musharaka* best fits the want of these parties.

Musharaka or *sharika* is defined as "partnership". This concept of this mode is similar to *mudaraba* but with minor variations. The phrase "share" is vital in this contract, since the partners are able to "share" several responsibilities e.g. capital, management, right of disposition, profits and "losses". "Sharing losses" is one of the major issues that distinguishes *musharaka* from *mudaraba*. Hence in the case of *mudaraba*, the investor or financier bears the total financial loss, and the agent manager damage is limited to losing his efforts that has been devoted for the venture. However, in the case of *musharaka*, all parties share the losses. In addition, the parties involved in *musharaka* contract are the agents of and not the guarantors of their colleague(s), and hence, this mutual agency is limited to the area of business covered by the partnership or to the extent of their joint capital.[40]

40 Saleh, Nabil(1986), Unlawful Gain and Legitimate Profit in Islamic Law, Cambridge University Press, U.K. p.93.

The practitioners and providers of Islamic financing illustrate that *mudaraba* and *musharaka* are; on relative basis, high in risk, specially when it the Islamic bank plays the role of the "investor" or the "financier". From this point, the other distinction between *mudaraba* and *musharaka* emerges. In the case of *mudaraba*, the Islamic bank due to the nature of the contract, has less control and influence on the agent manager, thereby this mode is regarded risky for Islamic banks. However, *musharaka* when compared to *mudaraba* is on relative basis less risky, because the nature of the contract provides the investor more room in the sense of influencing and sharing the decisions with other partners. Last not the least, Islamic law does not permit Islamic banks to require any collateral (security) from any of the partners in the both cases; *musharaka* and *mudaraba*. The only justification for having collateral is for the purpose of using it as a security to covering the risk resulted from the negligence or wilful wrongdoing of the partner or his non-compliance with the terms of the partnership contract.[41]

One of the distinctions between *musharaka* and *mudaraba* is the establishment of a new company or corporation in the case of *musharaka*. In the case of the latter, the capital provider and borrower (entrepreneur) set up a new company to share the profits and losses. There are issues for some *fiqh* schools as to whether or not such companies can be set up on a limited liability basis, however the critical difference between *musahraka* and *mudaraba* is the former normally entails the creation of a new (joint venture) company whilst *mudaraba* applies to existing companies.

41 Saleh, Nabil (1986), Unlawful Gain and Legitimate Profit in Islamic Law, Cambridge University Press, U.K. .p.95.

2.3.4 *Salam*

Salam (also called *Bay-Salaam*), is defined as sale whereby the seller agrees to supply the buyer with specified goods at a future date, and that is in exchange for an advanced payment paid in "full" and on "spot" by the buyer. In this contract, the buyer is called *rabb -salam*, the seller is called "*muslam ilaih*", the cash price is "*ras mal*", and the purchased goods are called *muslam fih*.[42]

In general, the seller bears the risk associated with *salam* and that is until the time of delivery. The buyer has the right to inspect the goods and furthermore, the buyer has the right to refuse taking possession of the goods on sight, and this is under the condition that the specification of the goods are not compliant with the description agreed upon.[43]

In early Islam, the *salam* contract was one of the alternative contracts of the prohibited *riba* based transactions. *Salam* contract was permitted by Prophet Muhammad at that time in order to enable small farmers to get some liquidity to grow their crops until the time of their harvest. Similarly, this contract provided liquidity to traders of Arabia so they will be able to trade, taking into consideration that these traders were unable to get any *riba* based loans. These days, Islamic banks rarely employ the *salam* contract. Vogel and Hayes suggest three problems associated with the use of *salam* as a "financing vehicle". First, there is the "risk of default" by the seller, whether "pledge" of "guarantee". The second problem is that the buyer does not have the choice of liquidating the goods until taking "possession" of them. The third problem is the most critical one, if the seller failed

42 Alrajhi Bank web site, available at: http://www.alrajhibank.com.sa/islamicebanks.htm, Internet, last accessed at 05/05/2001.

43 Al-Omar, Fuad, Abdel-Haq, Nuhammad (1996), Islamic Banking: Theory, Practice, and Challenges, Zed Books Ltd, London-U.K., p.18.

to supply the specified goods at the agreed time, the buyer has the choice to either return back what he has paid for, or await for the goods to be delivered when they become available. Aware that the buyer in the latter case is not allowed to receive any compensation from the seller. [44]

44 Vogel, Frank and Hayes Samuel (1998), Islamic Law and Finance, Religious, Risk, and Return, Kluwer Law International. Massachusetts-USA., pp. 145-146.

2.3.5 *Istisna*

This arrangement allows the "buyer" to perform a contract with the "manufacturer" to produce or manufacture a "specific" good for delivery in a "specific period" of time. The use of *istisna* by Islamic banks is increasing. These banks can employ *istisna* in many different applications, starting from shoelace manufacturing to aircraft manufacturing. Taking into consideration that the most schools of Islamic law allow the manufacturing party to outsource the manufacturing process by contracting a second *istisna* with a third party.[45]

The are a number of differences between *istisna* and *salam* contracts. First, in *istisna,* the buyer and manufacturer agree on the details of manufacturing process. However in the case of *salam*, the seller is only obliged to deliver the goods on time and according to the agreed specifications, and the manufacturer is not obligated to go through the details of the manufacturing process. [46] Secondly, the nature of goods in the case of *istisna* are those which can be manufactured. However in the case of *salam*, the goods are not necessarily manufactured. Thirdly, the buyer in the case of *salam* is obliged to pay the "full" amount and in "advance", however in the case of *istisna*, the price can be paid up front or with instalment payments.

45 Vogel, Frank and Hayes Samuel (1998), Islamic Law and Finance, Religious, Risk, and Return, Kluwer Law International. Massachusetts-USA., p. 147.

46 Ibid.

2.3.6 *Ijara*

Ijarah is defined as a process by which a "usufruct" of a particular asset is being transferred to another party "lessee" against an exchange for a claimed rent, the rental is paid to a party called "lessor". In many respects, *ijarah* is equivalent to "leasing" practiced in contemporary world, aware that in *ijara* the focus is on the usufruct and not the asset.

The Islamic Development (IDB) identities a number of conditions that makes an *ijara* a valid contract. The following is a summary of these conditions. (1) The contract of *ijarara* is terminated as soon as the asset stops to give the service for which it was rented. If the asset becomes damaged during the period of the contract, it will remain valid. (2) Both parties; lessee and lessor, are obliged to agree on the service or the usufruct resulted from using the asset. (3) The lessor retains legal title to the asset being financed, and the maintenance of the asset is the responsibility of the lessor. (4) In the case that lessee is interested in buying the rented asset at the end of the rental period, the price of asset might only be determined at the end of the rental contract. [47]

The trend among Islamic banks and other related financial institutions is towards providing a modified type of *ijara* called *ijarara wa iqtina* (hire-purchase). This mode of financing is similar to conventional mortgage financing. The lessee in *ijarara wa iqtina* pays the lease plus an additional amount which is directed towards buying the leased property, and this ultimately increases the lessee's ownership of the asset.

47 Operational Manual (1981), Islamic Development Bank, Jeddah-Saudi Arabia.

2.4 *Shariaa* Supervisory Boards

The different sources of Islamic contract law clearly emphasize that income earned by a Muslim must be *halal*. Yaqubу illustrates that:

> the concept of purifying the source of subsistence and source the income (*al-kasb al halal*) is very important and is very deeply rooted in the Muslim's education and psychology from the beginning of childhood.[48]

Consequently, the clients of Islamic banks are concerned that all of their dealings with the bank are inline with the basic tenets of the different sources of Islamic contract law. Hence, these clients are in favor of *Shariaa* Supervisory Board (SSBs) to ensure that all the financial dealings provided by the Islamic bank are *halal.* A SSB can be defined as a body established under a specific or general statute of an Islamic bank of a particular country with the main objective of ensuring that the operations of the bank are not violating any *Shariaa* principles. [49]

The sophistication of SSBs has visibly increased as they have gained experience with modern financial concepts and their applications on contemporary commerce. Two scholars assert the following:

> In the early phases of Islamic banking development, religious scholars were less familiar with the dynamics of financial markets and the impact of finance on business organizations and portfolio strategies. ... (In the following paragraph) Today, *shariaa* boards are more knowledge about modern finance and practical

48 Yaqubу, Nizam (1998), Islamic Finance: Evolution and Challenges, Proceeding of the Second Harvard University Forum on Islamic Finance, October 9-10, Harvard University, Massachusetts-USA., p.159.

49 See Haron, Sudin (1997), Islamic Banking : Rules and Regulations, Petaling Jaya, Selangor Darul Ehsan, Pelanduk Publications, Malaysia.

> requirements of investors and businesses, and they increasingly consider the intent as well as the letter of situations brought before them.[50]

The presence of the *Shariaa* Supervisory Board in Islamic banks, is another major aspect that distinguishes these Islamic banks from conventional (*riba*-based) banks. The requirement for a religious body that grants approval to the financial deals offered by Islamic banks is increasingly becoming a central issue in the Islamic banking industry. Taking into consideration that contemporary conventional financial practices are increasingly becoming more advanced and dynamic. Islamic banks are supposed to refer to a religious body in every new financial transaction for approval purposes. Note that the absence of a "unified" religious body responsible for issuing *fatwas* (religious rulings) and granting approval of new financial transactions, makes the issue more complex for Islamic banks.

In general, a SSB consists of a number of Muslim scholars who hold extensive knowledge in the different sources of Islamic law as well as sufficient knowledge in contemporary financial transactions. It is worth indicating the existence of these religious boards differs from one country to another and from one bank to another, the issue is mainly dependent on the Central Banks' regulations. For instance, in countries such as Iran and Pakistan, the existence of *Shariaa* Supervisory Boards is deemed "unnecessary". Because the governments of the these two countries tend to appoint their own "central" religious boards, and by this, these central banks assure that all Islamic banks are

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50 Vogel, Frank, and Hayes, Samuel (1998), Islamic Law and Finance: Religion, Risk, and Return, Kluwer Law International, Massachusetts-USA, p. 10.

applying the same Islamic rules. [51] On the other hand, in other Muslim countries such as Malaysia each Islamic bank is supposed to have its own SSB. The Central Bank will not recommend the granting of a license to Islamic banks in Malaysia unless it is satisfied that there is - in the articles of association of the bank - a provision for the establishment of a *Shariaa* advisory body. The SSBs of these Islamic banks operate under the supervision of the central bank. [52]

The duties of the SSBs differ from one Islamic bank to another. According to a scholar:

> The majority, however, do retain a SSB which meets occasionally and clears model transactions and contracts, and issues an annual statement attesting the adherence of the management to the advice and instructions of the *Shariaa* board vis-à-vis the religious aspects of the business. [53]

Yaquby; who is a member of many SSBs, mentions the following main duties of the SSBs. Initially (if the bank is in its initial stage) the committee investigates each bank's Articles of Association. The members also review every form and bank application, and sometimes take random samples of specific contracts. In addition, the SSBs educate both the staff of the banks as well as the wider public.[54] James, in an article listed in The Wall Street Journal, notes four functions of the SSBs. The board provides opinion on the activities of the bank and their compliance with Islamic laws. In addition, it endorses model contracts and standard agreements and ensures their compliance with the *shariaa.*

51 See Haron, Sudin (1997), Islamic banking : rules & regulations, Petaling Jaya, Selangor Darul Ehsan, Pelanduk Publications, Malaysia.

52 Naughton, Shahnz & Naughton Tony (2000), Ethics and Stock Trading: The Case of an Islamic Equities Market, Journal of Business Ethics, Jan, Vol. 23, Issue 2, Part 2, pp. (145-159).

53 Principles of Islamic Investing (2000), Dow Jones University online course., available at: www.dju.com, Internet, last accessed at 09/2/2000.

54 Yaquby, Nizam (1998),), Islamic Finance: Evolution and Challenges, Proceeding of the Second Harvard University Forum on Islamic Finance, Octobor 9-10, 1998, Harvard University, Massachusetts-USA.

The board is also responsible for seeing the activities of the bank in general and management's implementation of *shariaa* principles. Finally, the board is suppose to issue an annual declaration which accompanies the banks financial statement, recording the board's views on the compliance of the bank with the *shariaa* prerequisites. [55]

Moore emphasizes that the SSB is by no means a passive entity - on the contrary - it can have enormous decisive influence. The author asserts the latter by stating (in 1994), that Saudi Arabia's Al-Rajhi Banking and Investment Corporation has been forced to liquidate its currency fund when its *Shariaa* committee ruled that it failed to comply with Islamic Law. [56] It can be observed that the duties of SSBs are to a large extent dependent on the Islamic bank management. For instance in the case of Faisal Bank in Egypt, the status of the SSB is as follows:

> A Religious Supervisory Board shall be formed within the Bank to observe conformance of its dealing and actions with the principles and rulings of Islamic *Shariaa.* The bank Status shall determine the process of forming this board, the way it shall conduct business as well as its other functions. [57]

There are Islamic banks that grant their SSBs comprehensive responsibilities and authorities, such as the right to audit and investigate all of the operations of the bank. On the other hand, the responsibilities and duties of SSBs in other Islamic banks, are limited to replying to inquires and questions asked by the bank's management, in other words, the SSB is regarded as a "consultant" instead of a *shariaa* "auditor". Most probably these Islamic banks are afraid that the SSB interference in the day to day transactions and

55 See James, Jennie (1999), Equity funds: Islamic Funds Respect Strict Guidelines, The Wall Street Journal Europe Edition, 03-05-1999.

56 As cited from Moore, Philip (1997), Islamic Finance: A Partnership for Growth, Euromoney Publications.

57 Articles of Association of the Bank, Article 3 of Law Number 48/1977.

decisions will affect the bank's performance in a negative manner. Duncan[58] points out that the stringent requirements placed in terms of the *shariaa* have led to "resistance" from new customers. The latter source confirms that the users of Islamic finance have already begun to walk away from the market citing that they no longer wish to be involved in Islamic finance because of "stringent" requirements. In addition, Duncan highlights another problem of the SSBs, he asserts that some boards might consist of members that follow specific Islamic *fiqh* schools, and they find hard to agree with another. For instance, conservative Middle Eastern scholars, for often do not accept financial *fatwas* (Islamic rulings) that are issued by Malaysian scholars. [59]

It is worth indicating that one of the main challenges facing Islamic banks is the absence of "unified" rulings, and this lead to the problem that, for instance, Islamic banks in Malaysia have a completely different set of rules from those banks that operate from Middle Eastern countries. Hence, there is not any global *shriaa* entity or organization that serves as a reference for rulings with regard to Islamic finance and banking. And from this point, the issue of establishing a central SSB for Islamic banks and other related financial firms becomes a necessity.

In these days, the presence of SSBs has extended to include Islamic Equity Funds (IEFs). When it comes to the role of SSBs in the case of IEFs, the available literature is very limited. However, in general, the role of SSBs is focused on setting up screening

58 As cited in Moore, Philip (1997), Islamic finance: a partnership for growth, Euromoney Publications.

59 Moore, Philip (1997), Islamic finance: a partnership for growth, Euromoney Publications.

guidelines and acting as a consultant for the fund manager and other involved parties. Usually, the SSB members and the fund manager meet once or twice a year. During the meeting, the SSB responds to questions asked by the fund managers or other parties involved in the process.

The fund promoter or manager usually appoints all the members of the SSB, and the fund's shareholders are usually not involved in the selection process of the members of SSB. This raises a question mark on the extent to which the rulings issued by these members are reliable and credible. Thus, it is nonsensical for the fund promoter to select conservative Muslim scholars, or scholars with strict points of view on issues related to stock investing, because this automatically limits the qualified stocks in which the fund manager is able to invest in. In the same context, the fund manager's and promoter's privileges expand to include the right not only to appoint the members of SSBs but the right to dismiss any of the members, and this adds another question mark regarding the credibility of the role of SSBs in the case of Islamic Equity Funds.

It can also be observed that IEFs might function under different set of Islamic investment guidelines, the issue usually depends on the SSB of each fund. For instance, despite there is almost a mutual agreement among Muslim scholars in regards to the impressibility of using hedging techniques for reducing risks, there are several Islamic funds that employ these techniques. According to the prospectus of "Alkhawarizmi Fund"[60], part of the fund's main objective is "managing risk through hedging and efficient portfolio

60 The International Investor web site, available at:www.tii.com, Internet, last accesses at 21/09/2000.

management techniques e.g. short selling". The latter example assures that in the current Islamic investment market, there are fund mangers that are allowed to employ techniques that are regarded impermissible for other fund mangers, and hence, this issue leverages the unfair competition among different Islamic funds. Again, the importance of having standardized Islamic investment guidelines eliminates any unfair competition between fund managers of IEFs.

CHAPTER 3

THE SETTING ISLAMIC BANKING

3.1 Overview

This chapter is an attempt to explore the evolution of Islamic banks. In order to achieve this purpose, the chapter is divided into three parts. The first part explores the development of Islamic banking. The second part explores a relatively new topic in the literature on Islamic banking and finance, which is called "Globalisation and Islamic banking". This part attempts to clarify the readiness of Islamic banking to confront the results of globalisation. This part also suggests a number of strategies in which Islamic banks might pursue to confront globalisation in a proper manner. The last part is named Basics of Islamic Equity Funds". This part is related to the current chapter in the sense that Islamic Equity Funds are becoming one of the most recently provided financial products by Islamic banks.

3.2 Development of Islamic Banking

The Islamic legal principles that regulate the conduct and content of commercial transactions in Islamic finance date back to the early days of Islam in Arabia. At that time, these legal principles were derived from two injunctions; the Quran and the sayings of the Prophet Muhammad. The foundations of the principles that regulate the Islamic banking and finance industry today are derived from these two main injunctions, which were established over 1,400 years ago.[1] In the Middle Ages, these principles became the foundations for trade, commerce and other related businesses. In some European countries e.g. Spain and Baltic States, Muslim merchants and traders became indispensable middlemen. It is argued that European financiers and traders later adopted several principles and modes that were practised by the members of the Muslim community up until the growth of the European colonial empires.

During the period of the European colonial empires, Islamic commercial practices did not last for long. They were substituted with Western conventional inspired financial systems and business models. While the conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system additionally comprehensively focuses on other aspects of business such as ethical, moral, social, and religious dimensions. According to The Economist:

> One ancient and modern culture points to a distinct alternative. The clarity of Islam's anti-usury laws meant they were unchallenged until the 19^{th} century, when Islam came into frequent contact with western assumptions about banking. Then, however, things became mightily complicated. Western financiers argued that trade and economic development were only possible if Islamic countries adopted western financial methods. With time, some big ones, notably Saudi Arabia, did, and western-style commercial banks were created over the objections of theologians.[2]

1 See Moore, Philipe (1997), Islamic Finance a Partnership of Growth, Euromoney Publication.

2 The Economist (1993), Usury: the Lender's Long Lament, Dec 25, Vol. 329, Issue 7843, p. 106.

During the 1960s and 70's, the industry witnessed a number of serious scholastic efforts to develop theories and thought behind both the ethical and value systems of economics, which were tackled within the boundaries of Islamic principles. The major contributors included individuals such as Kurshid Ahmad, Muhammad Nejatullah Siddiqi, Ziauddin Ahmed, Muhammad Fahim Khan, Sami Hassan Homoud, Muhammad Abdul Manan, Muhammad Anas Zarqa, and Muhammad Umar Chapra.[3]

The year 1963 witnessed the establishment of the Mit Ghamr Local Savings Bank by an Egyptian named Ahmad Al-Najjar. The bank is operations were based on the profit (loss) sharing concepts, which is a basic concept in Islamic finance. Unfortunately, the bank only lasted for a short period due to several political pressures originated by Egypt's leader Abd Alnasser. The Mit Ghamr project had an unexpected success, as savings deposits increased from 25,000 Egyptian pounds to 125,000 during 1963-66. In addition, the bank functioned on a cautious basis, rejecting on average 60% of loan applications in the first three years. The default ratio was zero percent in "economically good times". [4]

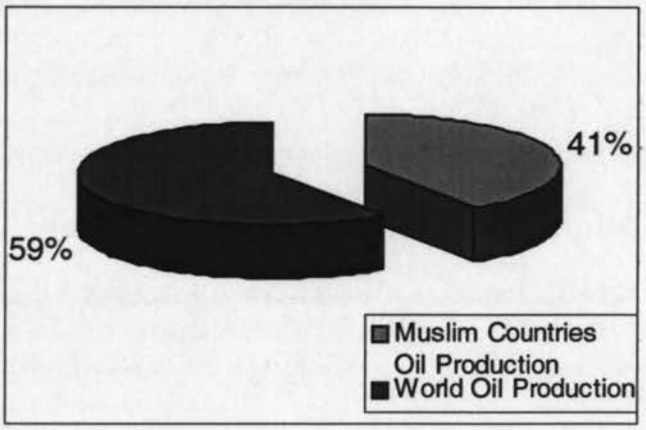
The oil discovery in a number of Muslim countries, especially in the Arab Gulf states, played a pragmatic role in the development of the practice of Islamic banking and finance. The surge in world oil prices during the early seventies poured billions of dollars into the coffers of oil-producing countries such as Iran and Iraq in addition to most

3 See Haron, Sudin (1997), Islamic Banking System: Concepts and Applications, Pelanduk Publications (M) Sdn Bhd, Malaysia.

4 See Ahmed, Ausaf (1995), The Evolution of Islamic Banking. Published in the Encyclopaedia of Islamic Banking and Insurance (1995), Institute of Islamic Banking and Insurance, London-UK.

countries in the Arab Gulf region e.g. Saudi Arabia, Kuwait and UAE. As Chart (3.1) indicates, the Muslim countries' share of oil production accounted for 41% of total world output, that is for the year 1997.

Chart (3.1)
Muslim Countries Petroleum Production Including Natural Gas Liquids (1997)[5]



The sudden change; (late 70s and until early 80s) that occurred in the wealth of the Arab Gulf countries, has underpinned the process of transforming the theoretical concepts of Islamic banking and finance into practice. A number of major Islamic banks, owned by individuals from the Arab Gulf region, were established during the oil boom. For instance, in 1975, the Dubai Islamic Bank in UAE was established as the first formal private interest-free bank. Two more private banks were founded in 1977 including Faisal Islamic Bank in Egypt and Sudan. In the same year, the Kuwaiti government set up the Kuwait Finance House.

5 Percentages are calculated from the figures available in the Financial Times Energy Years Book Oil & Gas (1999), Published by FT Energy, London - U.K.

Until the mid of 1970's, Islamic banks were still in an immature position; their efforts were directed to developing *halal* modes that can be substituted for *riba*-based financing. These attempts resulted in the development of the basic Islamic financial modes e.g. *murabaha, ijara, musharaka, mudaraba.* Also, the emergence of the Islamic Development Bank (IDB) in 1975 gave momentum to the Islamic banking activity. The establishment of the IDB was in pursuance of the declaration of intent issued by the Conference of Finance Ministers held in Jeddah in December 1973. According to Article 1 of the Articles of Agreement establishing the bank, the purpose behind the bank is the following, to:

> ... foster the economic development and social progress of the member countries and Muslim communities, individually as well as jointly, in accordance with principles of the *Shariaa.* [6]

Until the end of seventies, Islamic banking activity was dominated by the following four banks: Dubai Islamic Bank (UAE), Dallah Al Baraka (SA), and Dar Al-Maal Al-Islami (SA), and the Kuwait Finance House (Kuwait). These banks, especially Dallah Al Baraka and Dar Al-Maal Al-Islami, detected a huge potential in the Muslim market, and therefore started to expand in countries that are heavily populated with Muslims. One of the reasons that helped the outgrowth of these banks is the high demand generated by those "conservative" Muslims that preferred depositing their monies in Islamic banks so that the generated returns will be inline with the basic tenets of Islamic contract law. It is worth indicating that prior to the existence of Islamic banks, these conservative Muslims either kept their monies in safe-keepers at their home or deposited it in interest-free accounts with Western conventional banks, so as to avoid getting trapped in *riba*.

6 Islamic Development Bank web site, available at: www.idb.org, Intenet, last accessed at 05/03/2001.

In the 1990's, Islamic banking activity started to head towards standardization. The year 1990 witnessed the establishment of The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The main purpose behind the AAOIFI is the setting of international accounting and auditing standards in the area of Islamic financing. It is hoped that the AAOIFI will increase the transparency and accountability to Islamic banks. So far, the AAOIFI has produced twelve accounting standards covering a several range of issues including presentation and disclosures for banks and insurance firms. They have also issued three "auditing" and three "governance standards", a statement on the "code of ethics" and a statement on "capital adequacy". [7]

During the end of the last century, Islamic banks have developed a number of so called "collective schemes" such as Islamic mutual funds, private equity, different types of *ijara* and real estate investing. Malaika shows that the emergence of such schemes has facilitated bridging the gap between the traditional Islamic banking products and the modern investment products such as investment banking, asset management, portfolio management, financial advisory, underwriting, syndication, private and public placement of investments and financial engineering. [8]

These latter developments resulted in a dramatic surge in the number of Islamic banks, and this specially occurred during the end of nineties. Most estimates suggest that there

7 Abd, Rahman, Noor ur (2000), Issues in Implementing and Adapting to Islamic Banking, Paper presented in the Regulation of Islamic Banking Conference., 8th & 9th February, Manama- Bahrain, available at:
http://195.65.102.235/conferenceaaoifi/february2000/confpapers/GiathSebshighspeech.htm, Internet, last accessed at 28/03/2001.

8 See Saleh, Malaikah (1997), The Role Governments have to Play in Developing Islamic Banking, Keynote speech and paper delivered during the Fourth Annual Meeting of Islamic Banking & Finance Forum, December,Bahrain.

are currently more than 200 banks around the world that practice some form of Islamic finance. The focus of the transactions of these banks is directed to the Arab Gulf States. The end result, Islamic banking market is now worth multi billions of dollars; according Al Bahr:

> This market had grown from nothing to a US$100 to $150 billion market over the last in 18 years. It is currently growing around 10% a year. With in 8 to 10 years, this market will handle at least 50% to 60% of the total savings of Muslims worldwide. [9]

One of the most recent developments in Islamic finance and investing is the formulation of global equity-benchmark indexes, which are tailored for investors who follow Islamic investment guidelines. These indexes were formulated by Dow Jones (DJ) and the Financial Times London Stock Exchange Index (FTSE). Each index has appointed its own *Shariaa* Supervisory Board (SSB). The screening criteria in both indexes are very similar with some minor differences. The creation of these indexes reflects the growing interest by individuals in making investments that adhere to ethical guidelines, according to their beliefs. With these indexes, Muslim investors are able to measure the financial performance of Islamic Equity Funds. It is interesting to note that the majority of stocks included in these indexes are derived from Western stock markets, and it is very rare to find stocks derived from the stock markets of Muslim countries. The following is a breakdown of the Dow Jones Islamic Market Index (DJIM). The DJIM consist of 636 stocks, with 234 in the Dow Jones Islamic Market U.S Index, 32 in the Dow Jones Islamic Canada Index, 218 in the Dow Jones Islamic Market Asia/Pacific Index, 117 in the Dow Jones Islamic Market Japan Index, 127 in the Dow Jones Islamic Market Europe

9 Al Bahar, Adnan (1998), Islamic Finance: Evolution and Challenges, Proceeding of the Second Harvard University Forum on Islamic Finance, October, 9-10, Harvard University, Massachusetts-USA., p. 181.

Index, 43 in the Dow Jones Islamic Market U.K Index, 100 in the Dow Jones Islamic Market Extra-Liquid Index and 57 in the Dow Jones Islamic Market Technology Index.[10]

It is worth noting that in these days, the establishment of Islamic banks is not limited to those few the Arab Gulf, a new trend has emerged, international commercial banks have started offering Islamic finance products in order to get a share of the Muslim market. One of the first movers among these international banks was Citibank, who established Citi Islamic Investment Bank in Bahrain in 1986. Other major international banks followed the trend, for instance the Dutch bank, ABN AMRO, set aside an Islamic banking division to its offshore operation. In addition, HSBC recently entered the market with a strong momentum. As a result, Islamic banks are facing a tough competition from international banks. In this context, Wilson argues that Islamic banks and conventional banks should not regard each other as a threat, and hence, each of them can learn and benefit from the other. The author asserts that the main value added from the Islamic banks is their ability to draw on expertise in the *shariaa* law, in addition international banks can learn from Islamic banks the facets of "relationship banking" and how to attract clients by the "convergence of bank" and "customer values". On other hand, Islamic banks can utilise from the major multinational conventional banks with critical mass a number of professional financial and investment services e.g. identifying

10 Islamiq.com web site, available at:www.islamiqdaily.com/financial/art_fin4_22082000.htm, Internet, last accessed at 05/05/2001.

attractive financing opportunities, treasury management, foreign exchange, portfolio services and investment banking. [11]

11 Wilson, Rodney (2000), The Interface Between Islamic and Conventional Banking, Paper presented in the Fourth International Conference on Islamic Economic & Banking: Islamic Finance: Challenges & Opportunities in the Twenty- First Century, August 13-15, Loughborough University, U.K. , P. 399 (385-401).

3.3 Globalisation and Islamic Banking

Beshara asserts the "globalisation" is one of the defining terms of recent twentieth century "consciousness" whether the terms pertains to politics, economics, or even cultural identity. The author also asserts that the progress of globalisation is in a way linked with the development of "information technology".[12] Today's era of globalisation is built around falling walls and borders between different countries around the world especially with the existence of advanced and state of art technologies. The recent developments in information technology in areas such as wireless, satellites, fiber-optic and the Internet, is making the whole world one global village. Countries and corporations that master globalisation tactics are confidently able to reach traditional nation-states in a further, faster, cheaper and, most important a more efficient manner.

Friedman in his book titled "The Lexus and the Olive Tree" defines "globalisation" as: "The integration of capital, technology, and information across national borders, in a way that is creating a single global market, and to some degree a global village."[13] The author asserts that free-market capitalism is a central force in the sense of underpinning globalisation, and hence, the more countries allow market forces to dominate, the more advantageous and prospering the economy gets. These market forces function better under certain economic rules, which include deregulation and privatisation. [14]

12 Beshara, Miranda (1999), Globalization and the Middle East: Growing Together or Growing Apart, Middle East Institute, available at: http://209.196.144.55/html/besharab.html, Internet, last accessed at 03/03/2001.

13 Friedman, Thomas L. (1999), The Lexus and the Olive Tree, Farrar, Straus and Giroux, New York-USA., cover page.

14 Ibid., p.8.

The financial sector is unquestionably one of the sectors that is influenced by the globalisation trend. Islamic banks, as they function under the financial sector, are certainly affected. The question in this context is; how would Islamic banks be affected by this trend? Do Islamic banks have a clear strategy for dealing with globalisation? Or may be these banks are not concerned with the globalisation trend, because their focus is limited to local Islamic investors and customers? Perhaps these banks feel threatened, especially in the light of the involvement of international conventional banks in the business of Islamic banking and finance. In order to be able to explore these questions, it is necessary first to clarify how the financial world is evolving because of the globalisation trend.

When discussing globalisation, it is essential to refer to the World Trade Organisation (WTO). It can be argued that membership of the WTO and adaptation to its rules and regulations can be both advantageous and disadvantageous to Muslim countries, the issue is heavily dependent on the readiness of these countries to enter such an organisation. In general, countries that join the WTO procure a number of issues, one of them is that the membership and compliance with WTO obligations encourages greater private sector participation, thus increasing competition, efficiency, product diversification and most important opening local markets for foreign competition. In regards to Muslim countries especially Arab Gulf countries, the governments of these countries usually protect certain industries from foreign competition especially high profitable services and industries e.g. oil industry and financial services including Islamic banks. In light of WTO, these countries need to redraft any policies that encourage the protection of local industries, and ultimately this will allow foreign banks to competing in their local markets. In short, it is apparent that the task facing Muslim countries in joining the WTO requires a reforming of these countries' legal, commercial and trade structures. And the question is that once these reforms are undertaken are local banks and especially Islamic banks able to compete with other well-established foreign banks?

It is argued that there are four trends fundamentally altering the financial world: consolidation of institutions, globalisation of operations, development of new technologies, and universalization of banking.[15] The most apparent trend among the latter, is the consolidation of financial institutions through mergers and acquisitions (M&As). This consolidation is expected to have significant financial and legal implications on both regional and global basis.

One of the results of globalisation is the collaboration between conventional banks with "high tech" conglomerates, which has resulted in the emergence of the so-called "virtual banks" or "Internet-banking". This collaboration amplified the dominance of the world's traditional financial trading centres such as USA, London, Hong Kong, and Frankfurt. These days, by clicking the mouse, investors and traders are able to instantly conduct any financial transaction with enormous amounts of cash e.g. billion of dollars. Daily foreign exchange trading in 1900 was measured in millions of dollars. In 1992, it was $820

15 Balino, Tomas and Ubide Angel (2000), The New World of Banking, Finance & Development, June, International Monetary Fund, Washington-USA, pp. 41-44.

billion a day, and by April 1998 it was up to $1.5 trillion a day, and still increasing.[16] All of these trends have allowed globalisation to advance at a greater distance and to reach retail customers especially among untapped foreign markets. Some banks are benefiting from Internet banking in order to avoid the high cost process resulting from building retail brick-and-mortar networks of branches.[17]

Balino and Angel argue that the fruits of globalisation are being captured by Western conventional banking groups' exploitation of the growth potential in untapped emerging economies.[18] For instance, at the current time, markets are witnessing the expansion of Spanish banks in Latin America, German banks in Eastern Europe, and U.S. banks in East Asia, and most lately the expansion of British and American banks in the Middle East region.

The globalisation trend has also affected Muslims around the world. For example, AlWaleed Bin Talal, a prince from the Saudi royal family, who is regarded as one of the richest individuals around the globe. In 1999, Serwer from Fortune Magazine performed an extensive interview with the prince; the article indicated that the total assets held by the prince are estimated around $17.2 billion. Part of his worth is invested in the Middle East and Africa region i.e. building pay-phone networks in Syria and Saudi-Arabia. In

16 Friedman, Thomas L. (1999), The Lexus and the Olive Tree, Farrar, Straus and Giroux, New York-USA, p. xv.

17 Balino, Tomas and Ubide Angel (2000), The New World of Banking, Finance & Development, June, International Monetary Fund, Washington-USA, pp. 41-44.

18 Ibid.

addition, he recently bought a 50% stake of Arabia Online, an Arab Internet portal. However, all of this is minor when compared to his investments in the stock exchanges of Western countries. A large chunk of Bin Talal's wealth is invested in several conglomerates around the globe. The following is a breakdown of his portfolio of stocks:

- $8.9 billion invested in Banking e.g. Citigroup
- $2.2 billion invested in Media & Advertising e.g. Saatchi & Saatchi
- $2.0 billion invested in Technology e.g. America Online, Motorola
- $1.1 billion invested in Hotels e.g. Four Seasons, Movenpick
- $0.5 billion in Private assets
- $1.1 billion in Cash
- $1.4 billion in others. E.g. Euro Disney, Daewoo, Saks Fifth Avenue, TWA.[19]

This portfolio indicates that the Bin Talal's investments are clearly induced by globalisation. In addition, it is clear that he is far from being characterised as a "conservative" Muslim investor, taking into consideration that about $8.9 billion of his wealth is invested in Citigroup which is a leading *riba*-based financial institution. Further evidence is Bin Talal's $1.1 billion investment in the Four Seasons and Movenpick hotels. Again, Muslims are strictly prohibited to invest in hotels due to alcohol and gambling matters. In short, despite that the prince is from one of the most conservative countries in the Middle East, his wealth is invested in mature global markets, and most importantly in non- *halal* business lines. Now the case of AlWaleed Bin Talal is one part the story, taking into consideration that such investment style is regarded as "liberalised" from an Islamic perspective. On the other hand, there are Muslim investors who attempt to invest according to the rules derived from the different sources of Islamic contract law. For instance, these Muslims deposit their money in Islamic banks. When it comes to investing in stocks, they only invest in Islamic Equity Funds in order to ensure that their

19 Serwer, Andy (1999), Tech is king; Now meet The Prince, Fortune Magazine, Dec 6, Vol. 140, Issue 11, New York, p. 116 (104-118).

stock's returns are *halal*. These Muslims are also able to finance their short-term needs by *murabaha*, and are able to acquire real estate via the *ijara* mode. It can be argued that the existing financial services and products provided by Islamic banks are more suitable for those Muslim investors with adequate financial ability, or those local Muslim investors with limited demands. However, when it comes to dealing with large sums of money or dealing with global corporations, Islamic banks are not the best alternative. Accordingly, in such cases, Islamic banks refer back to international banks and global financial firms. For instance in the case of Islamic Equity Funds, the role of Islamic banks is limited to two main issues: (1) covering the religious aspect of the fund by appointing the *Shariaa* Supervisry Board (SSB), and (2) promoting the fund on local basis. However, when it comes to the process of managing these funds, Western investment firms do the job, taking into consideration the professional expertise and resources these firms own. Having said that, it is worth indicating that the rules of the game are changing, currently conventional international banks are not only managing Islamic Equity Funds, but these banks are going through the whole process, starting from the appointment of the SSB to marketing these funds on a local basis, and this is occurring in light of the deregulation of financial sectors in Muslim countries, which, in turn, is one of the results of globalisation.

It can be argued that one of the challenges resulting from globalisation pertains to the rate of return in which Islamic banks pay to their customers. For instance, Islamic banks might face tough competition from conventional banks especially when the latter banks pay high rate of returns on deposit accounts. In this context, it must be mentioned that there is no doubt that Muslim investors might need to accept the cost of seeking *halal* income and this cost might be on the account of the reduced returns. In other words, Muslim investors might need to trade off financial gains for adhering to ethical standards.

In this context, the following critical questions emerge: what is the strategy of Islamic banks facing globalisation? How do Islamic banks protect themselves from the potential dominance of the mega conventional banks? It is essential initially to indicate that Islamic finance and banking is an "immature" industry that is not only being threat by globalisation, but has its also have their own serious problems. For instance, Islamic banks lack an "Islamically valid" instrument designed for the purpose of employing short-term liquidity investments, since these banks in most cases are required to match their investments to the short-term nature of their deposits. Conventional banks certainly do not face this problem. These conventional banks are able to deposit any excess of cash in daily "overnight" accounts, and hence such type of accounts in prohibited in Islam due to *riba*.[20] In addition, Islamic banks lack the expertise and qualified employees especially when it comes to tailoring sophisticated financial products and services. Therefore, these banks out source many sophisticated financial services e.g. fund management, investment banking, private banking and brokerage services from professional conventional banks.

Another major problem pertains to the lack of innovation in the theory and practice of Islamic banking and finance. For instance, Islamic banks are still unable to figure out an effective "Islamically" valid tactic for dealing with risks, noting that conventional hedging tactics are banned in Islam. What makes the problem more complicated is that

20 Vogel, Frank & Hayes Samuel (1998), Islamic law and Finance, Religious, Risk, and Return, Kluwer Law International. Massachusetts-USA., pp. 235-236.

Islamic banks are still unable to "Islamize" these contemporary conventional tactics e.g. (options, futures, swaps, and other hedges) due to *gharar* and *riba*.

Islamic banks might be able to integrate in the global financial system. Or should Islamic banks pursue a strategy of "separation" from globalisation. Currently, it can be argued that the greater number of Islamic banks are "separated" from the global market. So far, these Islamic banks are centred on the wealth of local Muslims, and consequently, the current provided financial products and services are tailored in a way to satisfy the locals. It is can be argued that these banks are in a safe position as long as the laws and regulations of the country forbid international and foreign banks from operating in local markets. However, in the light of globalisation, the governments of Muslim countries might need to "deregulate" their financial sector, and this will ultimately permit international banks to function in these "untapped" countries. Dudley mentions that:

> In three years' time, the four GCC states - Kuwait, Bahrain, Qatar and the UAE - which are members of the World Trade Organisation (WTO) will have to be ready for even tougher competition from global banks. This is because WTO rules compel states to open up their financial markets to foreign banks from 2003. [21]

There is no doubt that Muslim countries and more specifically Islamic banks are required to be properly prepared for globalisation. As long as Islamic banks are not positioned for globalisation, they might loose their edge in their own local markets, since one of the outcomes of globalisation is the permitting of foreign conventional banks to enter local markets. Note that foreign banks are on relative basis more experienced and own the required professional resources that aid them to expand and compete with local Islamic

21 Dudley, Nigel (2001), Arab Banks Begin to Modernize, Euromoney, May, Issue 385, London, p. 53 (52-58).

banks in a very efficient manner. Perhaps one of the few obstacles these foreign banks fear is lack of the preferences of local customers.

Compared to separation strategy, there are other Islamic banks that attempt to "integrate" in the new financial global system. These banks intend to expand their clientele base on regional basis rather than being focused on local markets. It is observed that there are very few Islamic banks expanding their physical presence in foreign countries; specially those ones which include great masses of Muslims. For instance, Al Baraka Investment and Development (Saudi Arabia) has subsidiaries in more than twenty countries around the world.[22] It can be argued that the strategy of integrating by the way of increasing the physical presence is associated with several problems. One of these problem is related to regulations, e.g. FDI regulations, financial sector regulation and licensing procedures. Islamic banks (in particular) face this problem when they intend to expand in Western countries, aware that most of these countries are not familiar with Islamic type of banking. For instance, until recently, Islamic banks were unable to operate in the USA due to regulation problems. A suggested solution for this problem is that Islamic banks need to consider establishing joint ventures with other local Islamic or conventional banks. This alternative might be more viable for Islamic banks to pursue. By partnering with local banks, Islamic banks would overcome the problem of obtaining the required licensing and other legal complications. In addition, Islamic banks might face fewer problems in identifying and coping with preferences of local customers. This strategy has been pursued recently in the case of establishing The Islamic Bank Bangladesh Limited

22 Albaraka web site, available at: http://www.albaraka.com/english/corporate/location.html, Internet, last accessed at 05/05/2001.

(IBBL). A number of well-established Islamic banks in the Arab Gulf, in addition to other governmental bodies of Muslim countries, have combined their financial resources with some local investors in Bangladesh. Nearly 65% of the bank's equity is contributed by the Islamic Development Bank (S.A.) and financial institutions such as Al-Rajhi Banking & Investment Corporation (S.A), Kuwait Finance House (Kuwait), Jordan Islamic Bank (Jordan), Islamic Investment and Exchange Corporation of Qatar (Qatar), Bahrain Islamic Bank (Bahrain), Islamic Banking System International Holding (S.A), Dubai Islamic Bank (UAE) and the Kuwait Ministry of Awqaf and Islamic Affairs. [23]

Islamic banks might also consider merging or collaborating with global conventional banks a valid option. This option enables Islamic banks to have access to Western financial markets, and also get professional financial assistance from those Western professional banks. It is worth mentioning that one of the apparent results of the collaboration between Islamic banks and Western conventional banks is Islamic Equity Funds (IEF). Islamic banks that are active in offering and promoting IEFs include: Albaraka Islamic Investment Bank (Saudi Arabia), Al Amin Securities & Investment Co (Bahrain), The Saudi National Commercial Bank (Saudi Arabia), Shamil Bank of Bahrain EC (Bahrain), The International Investor (Kuwait), Kuwait Finance House (Kuwait), Al Rajhi Banking & Investment Services (Saudi Arabia). These Islamic banks are collaborating with Western conventional banks including CitiBank (U.S.A), HSBC (U.K.), Merrill Lynch (U.S.A), Nomura Investment Banking (Japan), ChaseFleming

23 Alrajhi Bank web site , available at :http://www.alrajhibank.com.sa/islamicbankingcountries.htm, Internet, last accessed at 10/05/2001.

Asset Management (US)., Kleinwort Benson (U.K.), and Wellington Management (U.S.A).

Another strategy that can by employed by Islamic banks tending to cope with globalization, is to exploit the development of information technology (IT) in financial services e.g. virtual banking, Internet banking and on line brokerage services. In this aspect, Islamic banks have much to learn from Western conventional banks that are in the business of virtual banking. In this type of banking, technology replaces a number of major operations formerly performed by employees. Virtual banking involves linking automated teller machines, data warehouses and the Internet with customers, and this ultimately is suppose to drive down overhead related costs.[24] Currently, the online banking (virtual banking) market is segmented into two types of banks: multi-channel banks and Internet-only banks. Multi-channel banks have both off-line and "Web" presence, while Internet-only banks count on only on their Web site for customer dealings.[25] Whatever of the latter two methods Islamic banks desire to pursue, these banks are required to either in-source the required technology or out-source it from specialised IT firms. It is worth noting that the implementation of IT is associated with high capital expenditures especially in the initial phases of the implementation process.

24 Johnson, Thomas (2001), Putting Technology in its Place, Banking Strategies, May/Jun, Vol. 77, Issue 3, Chicago, pp. 4- 5.

25 Rakowitz, Robert and Others (2001), Differences Between Multichannel Bankers and Internet-Only Bankers, February, available at: www.jupiter.com, Internet, last accessed at 05/05/2001.

3.4 Basics of Islamic Equity Funds

3.4.1 Introduction

Islamic Equity Funds are becoming one of main investment products offered and promoted by Islamic banks especially those in the Arab Gulf region. These funds allow Muslim investors to participate in investing in tradable stocks available in financial stock markets. And most importantly, the returns generated from such investments are supposed to be within the boundaries of the different sources of Islamic contract law.

The focus of part three of this chapter is limited to Islamic Equity Funds. It is hoped that the following three purposes are achieved. First, an attempt is made to identify the different types of mutual funds and analyze these types from an Islamic perspective. Secondly, the focus is shifted to clarifying the different types of Islamic mutual Funds and the share of each one in the market. The third purpose is clarifying what are the advantages and rewards Muslim investors gain from investing in mutual funds in general, and more specifically in Islamic Equity Funds.

3.4.2 Analysing Different Types of Mutual Funds from an Islamic Perspective

There are several ways of dividing mutual funds, one of these is dividing these funds into closed-end and open-end funds. The shares in open-end funds could be redeemed or issued at their net asset value (NAV), which is the market value of all cash and securities held by the fund divided by the number of outstanding shares. On the other hand, the shares in the case of closed-end funds are not issued or redeemed at net NAV. Shares of closed-end funds are traded through organised exchanges and can be purchased through brokers just like other common stock.

Mutual funds also can be divided into the following three types: money markets, bonds, and stocks (also called equity) funds. Money market funds usually invest in short-term investments e.g. CDs and Treasury bills, and the shareholders of this type of fund seek income, liquidity, and a stable share price.[26] Another type of money market funds is called general purpose funds. Such funds invest in short-term debt of firms with specific characteristics. Another category of money market funds is the municipal money market fund, which invests in debt obligations of governmental related states and agencies.[27] The second type of mutual funds is bond mutual funds. This type of fund emphasizes on current income by investing in corporate, municipal, or governmental debt obligations or some combination. There are four main types of bond funds. First, there are government bond funds, which invest in securities issued by the government and related agencies. Second, there are mortgage-backed securities funds, which invests' in securities that represent interests in pools of residential mortgages. Third, corporate bond funds, which

26 See Pozen, Robert (1998), The Mutual Fund Business, The MIT Press, Massachusetts-USA.

27 Vanguard Educational web site, available at: www.vanguard.com, Internet, last accessed at 28/03/2001.

invest in the debt obligations of large firms. And fourth, municipal bond funds, such type of funds are focused on tax-exempt bonds issued by state and local governments. [28]

For Muslim investors, money market funds and bond mutual funds are prohibited. The reason is that these types of funds are involved in *riba* (usury), and hence, one of the basic tenets of Islamic contract law is prohibiting Muslims from dealing with usury-based financial products. For instance Allah mentions in the Quran:

> Those who swallow usury cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is just like usury; whereas Allah permitteth trading and forbiddeth usury. He unto whom an admonition from his Lord cometh, and (he) refraineth (in obedience thereto), he shall keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who returneth (to usury) - Such are rightful owners of the Fire. They will abide therein.[29]

The third type of fund is common stock mutual fund or sometimes named equity mutual fund. The shareholders involved in this type of fund tend to generate income either by capital appreciation or dividend income. There are several types of mutual equity funds; which usually depend on the main objective of the fund. For instance, mutual equity funds might include growth funds, value funds, blend funds (a combination of value and growth), large-cap funds, mid-cap funds, small-cap funds, sector funds, and international stock funds.[30] Jones asserts that growth funds and value funds are the most common types of stock (equity) funds. He mentions that:

> Most stock funds can be divided to into two categories, value funds and growth funds. A value fund generally seeks to find stocks that are cheap on the basis of standard fundamental analysis yardstick, such as earnings, book value, and dividend yield. Growth funds, on the other hand, seek to find companies that are expected to show rapid future growth in earnings, even if the current earnings are poor or, possible, nonexistent. [31]

28 Vanguard Educational web site, available at: www.vanguard.com, Internet, last accessed at 28/03/2001.

29 The Quran: al-Baqarah [2:275.4].

30 Vanguard Educational web site, available at: www.vanguard.com, Internet, last accessed at 03/03/2001.

31 Jones, Parker (1996), Investments: Analysis and Management, 5th edition, Wiley & Sons, Inc., p.55.

From an Islamic perceptive, equity funds are permissible but with certain restrictions. The central issue is that any stocks included in the fund need to go through screening criteria. The purpose behind the criteria is to screening out all of stocks of firms that are involved in impermissible issues e.g. gambling, alcoholic drinks. In addition, the fund manager is restricted from employing certain financial tools e.g. derivatives and margin trading. Vogel and Hayes mention the following.

> Recently funds have been created to hold portfolios of stocks, these securities having first been vetted to ensure that their issuers meet certain criteria: e.g., that they hold law debt below a certain percentage of their assets, that interest income they receive falls below certain percentages total of income, and that they are not invested in forbidden activities such as gambling or the production of liquor or pork.[32]

There is an additional fourth type of mutual funds called "hybrid funds", this type is less common than the other types of mutual funds. Hyprid funds usually invest in several different financial assets at the same time. The following four examples pertain to hybrid funds:

(1) Asset allocation funds: these funds invest in a mix of equities, fixed-income securities and money market instruments.
(2) Balanced funds: which invest in a specific mix of equity securities and bonds.
(3) Flexible portfolio funds: these funds invest in common stock, bonds, and other debt securities.
(4) Income mixed funds: which invest in a variety of income-producing securities e.g. equities and fixed-income securities.[33]

In general, hyprid funds are prohibited in Islam. The main reason is that most of these funds are involved in fixed-income types of securities, which involve *riba* and as mentioned before *riba* is prohibited in Islam.

32 Vogel, Frank & Hayes Samuel (1998), Islamic Law & Finance: Religion, Risk, and Return, Kluwer Law International, Massachusetts-USA, p. 167.

33 Investment Company Institute, A guide to Mutual Funds, Available at: http://www.ici.org, Internet, last accessed 28/03/2001.

3.4.3 Types of Islamic Mutual Funds

To a certain extent, Islamic mutual funds are divided differently from conventional mutual funds. The basis of dividing the former depends on the employed Islamic financial technique. As indicated in (3.1), the current Islamic funds include: stock funds, trade finance funds, realty and property funds, leasing funds, and cash management funds. Islamic mutual funds additionally include: balanced funds, commodity funds, short-term liquidity funds, and *musharaka* funds. It is worth noting that most of these different types of Islamic mutual funds are associated with an Islamic financial technique. For instance, *musharaka* funds are based on *musharaka*; which is a primary technique in Islamic finance. In this fund, shareholders and other parties directly involved in the fund e.g. fund manager and fund promoter, share any profits or losses achieved during the life of the fund. It is central that the sharing percentage of loss or profit is pre-determined. As indicated in table (3.1), there is only one fund under the category of *musharaka* funds, which is promoted by Riyadh Bank in Saudi Arabia, and this fund has been launched in the year 1999. Another example is leasing funds or sometimes called *ijara* funds. This type of fund is obviously based on the *ijara* Islamic finance technique, and usually involves real financial assets e.g. airplanes, real estate, and ships. Furthermore, trade finance funds are built on *murabaha* technique, and in also involves trading real financial assets.

It is observed from (3.1), that Islamic stock funds - usually named Islamic Equity Funds- account for 63% of the total Islamic mutual funds. According to the Islamic Banker numbers[34], around 50% of Islamic equity funds are invested globally i.e. invest in different stock markets around the world, especially those located in the developed Western countries.

Table (3.1)[35]
Breakdown of Islamic Mutual Funds (2000)

Type of Funds	No. of Funds	(%)
Stock Funds	57	63
Trade Finance Funds	12	13
Realty & Property Funds	6	6.6
Leasing Funds	5	5.5
Cash Management Funds	3	3.3
Balanced Funds	2	2.2
Commodity Funds	2	2.2
Short Term Liquidity Funds	1	1.1
Musharaka Funds	1	1.1
Mutual Investment Funds	1	1.1
Total	90	99.1

It is worth indicating that Islamic Equity Funds became familiar during the nineties. During this period, a number of Islamic legal opinions were issued, in which permitted Muslims to trade with stocks but with certain restrictions. One of the first formal Islamic legal rulings on stock investing returns back to 1992. At that time, the *Fiqh* Academy (Based in Saudi Arabia) declared that:

> ... owning shares in companies formed for unlawful purposes is entirely improper. But owning shares in companies that only sometimes engage in forbidden activities like *riba* is unlawful only in principle. [36]

After six years for the latter ruling, the Academy declared:

> As long as the assets represented by the securities are in greater part (al-ghalib) by value real assets (a'yn wa-manafi') as opposed to cash or obligations (dayn), then trading of the securities becomes permissible.[37]

34 Islamic Bankers (2000), Issue. 56, September, Mushtak Parker Associates Ltd., London-UK.

35 Ibid.

36 *Fiqh* Academy Journal 1:711,712, Decision [65/1/7], Seventh Session (1992), Saudi Arabia.

37 *Fiqh* Academy Journal 3:2161, 2163, Decision [d4/08/88], Fourth Session (1998), Saudi Arabia.

There are two well-known Islamic global equity funds, the first is Citi Islamic Portfolios A & B, which is promoted by Citi Islamic Investment Bank (Bahrain) and managed by Citi Islamic Portfolios (Saudi Arabia). In Sep 1999, the total size of the fund accounted for $104.3 million[38]. The other major Islamic global fund is the Al-Ahli Global Trading Equity, which is promoted by the National Commercial Bank Investment Services (Saudi Arabia), and managed by Wellington Management Constancy (Boston-USA). In September 1999, the total size of the fund accounted for 667.4 million[39]. The fund was launched in January 1995, and is considered one of the largest Islamic equity funds in the world.

The International Investor (Kuwait), provides several different Islamic mutual funds. For the year 2000, the outstanding funds equalled seven [40]. Table (3.2) consist of a list of Islamic funds promoted by The International Investor and the objective of each:

Table (3.2) [41]
Islamic Funds Promoted by The International Investor

Name of fund	Objective of fund
Alkhawarizmi Fund	achieve long-term capital growth while managing risk through hedging and efficient portfolio management techniques e.g. short selling.
Ibn Majid Emerging Markets	achieve capital growth by investing in emerging market equities that are mainly comprised in the IFC Index
TII Small-Cap European Equities	achieve long-term growth equity investment in European companies which have a market capitalization of less than $900 million.
Al-Dar Eastern Europe	share in the growth of Eastern European equity markets.
Al-Dar European Equities	share in the growth of developed European markets by investing in European equities.
Al-Dar World Equities	achieve long-term capital growth and diversification by investing in major equity markets.
Al Bukhari Global Equity	achieve long-term capital growth from US and international securities while managing risk through efficient portfolio management techniques

38 Failaka International Report/ Third Quarter 2000, published by Failaka International., USA.

39 Ibid.

40 Ibid.

41 Ibid.

It is observed from table (3.2) that the main objective of the Alkhawarizmi Fund is managing risk through hedging and efficient portfolio management techniques e.g. short selling. The latter fund is one of the few cases in which risk is managed through hedging, aware that the fund manager in the case of IEFs is banned from employing any hedging techniques due to *gharar* and *riba* issues.

3.4.4 Rewards of Islamic Equity Investing

Mutual fund investors usually tend to maximise returns for a degree of risk. Muslim investors tend to achieve the same latter purpose, however with several religious concerns. The central issue for Muslim investors is that any earned return must be compliant with the basic tenets of Islamic contract law. Muslim investors attempt to avoid engaging in impermissible activities and furthermore seek to achieve religious rewards (*Thawab*).

It is argued that investing in mutual equity funds is accompanied with a number of advantages. For certain investors, these advantages make investing in mutual funds a proper alternative. Bogle illustrates that:

> The mutual fund represents a conveniently packaged investment program, offering the advantages of diversification and professional investment counseling, with management custodial, and administrative services provided, often low cost relative to alternative investment programs. [42]

Graham clarifies a number of advantages resulted from engaging in investment funds. He asserts that such type of investing has promoted rightness habits especially when it comes to savings. Garaham also asserts that investing in investment funds have protected stock market participants from falling in costly mistakes in the stock market; and investing in these funds have brought their shareholders income and profits "commensurate" with the overall returns from stocks. [43]

42 Bogle, John and Duffuield, Jeremy (1982), Mutual Funds. In Friedman, Jack ed. (1990), Encyclopedia of Investments, Warren, Gorham & Lamont, Inc. Boston-USA., p.431.

43 See Benjamin, Graham (1973), The Intelligent Investor: a Book of Practical Counsel, Harper & Row, New York – USA.

The following summarises the rewards that Muslim shareholders are expected to gain by investing in Islamic Equity Funds. These rewards may be divided into both general and religious. The general rewards are achieved when a Muslim investor intends to invest in any general fund and not particularly in an Islamic Equity Fund. And the religious rewards are those that result from investing in only Islamic Equity Funds or any *halal* type of investment. The following illustrates more on this issue.

(A) General Rewards

- Financial return

As mentioned previously, shareholders of mutual funds tend to maximise their returns for a given degree of risk. These returns are either generated by any distributed dividends or interest payments, or by capital appreciation, which results from the increase in the market value of the shares included in the fund, and in some instances the investor is able to generate both latter sources of returns. Investors who seek capital appreciation usually invest in growth equity funds. Investors interested in maximising income return tend to invest in fixed-income funds. Investors are also able to invest in certain funds called balanced funds or sometimes called hybrid funds. These funds enable the investor to achieve both capital appreciation and income return.

One of the main challenges facing Islamic Equity Funds is transparency, especially when it comes to presence of any information related to the financial performance of Islamic Equity Funds. The problem is that the regulations in most Muslim countries does not force fund promoters and managers to publish up to date information on the financial performance of their funds. Yet and without generalizing, it has been argued that for those Islamic funds invested in the Western stock markets performed fairly well (on relative basis), especially for the period 1996 to 2000. Hall points out:

> Some religious funds have performed even better than others. For instance, Amana Growth ... Amana Income have all posted relatively good returns, landing in the top half of their Morningstar categories over the trailing three-year period.[44]

Table (3.3) shows the five year annual return of "Amana Mutual Fund Trust Growth". This fund is regarded as one of the oldest Islamic Equity Funds, and the fund assets are mainly invested in particular stock markets of the USA. It is observed for the year 1998, that the return of the fund reached almost 25%. This year was one of the best years for technology stocks.

Table (3.3)[45]
Total Return 5year of Amana Mutual Fund Trust Growth

Year	1996	1997	1998	1999	2000
Total return %	25.5	12.9	24.5	14.1	8.7

One of the reasons behind such performance is due to that a significant percentage of these funds are invested in high tech and communication related sectors, and both of these sectors were performing strongly for the period 1996 to 2000. It is argued that the reason behind focusing on the latter two sectors is due to the limited number of Islamically qualified sectors. The fund manager in the case of Islamic

44 Hall, Emily, How Do Socially Responsible Funds Stack Up?, available at : http://news.morningstar.com/news/MS/Article/0,1299,3179,00.html, Internet, last accessed 31/03/2001.

45 Morningstar Inc., web site, available at: http:morningstar.com, Internet, last accessed at 31/03/2001.

Equity Funds is supposed to avoid investing in sectors involved in impermissible types of businesses e.g. financial services, leisure and entertainment related sectors.

- Professional investment management

Shareholders of mutual funds are able to benefit from the professional skills and resources provided by the fund manager. These skills and resources are supposed to leverage the fund manager's ability in selecting an appropriate portfolio of stocks. Hirt mentions the following:

> With a mutual fund, you are also buying the expertise of the fund management. In many cases, fund managers have a long history of investment experience and may be specialists in certain areas such as international securities, gold stocks, or municipal bonds. [46]

As for the case Islamic Equity Funds, Islamic banks do not have the appropriate professional skills to manage these Islamic funds. In this sense, the duty of Islamic banks is limited to promoting and marketing the fund, in addition to covering any religious aspects. It is very common that Islamic banks outsource the investment management services from Western conventional financial institutions such as HSBC, Flemings, and Wellington Management. It is worth mentioning that Islamic banks usually tend to ensure that the funds collected from Muslim investors are handed to trustful fund managers. It is not necessary that fund managers from conventional banks hold the religion of Islam. Contrary to that, most of the fund managers who manage Islamic Equity Funds are non-Muslims. Noting that there are many fund managers in the West with very high reputation especially when it comes to the issue of ethics. Tanous in his book: "The Wealth Equation" has surveyed 100 top money managers in USA. Fifty eight percent

46 Hirt, Goeffrey (1999), Fundamentals of Investment Management, Irwin / McGraw-Hill, p. 536.

(58%) of the respondents mentioned that they regularly attend church services. Thirty five percent (35%) answered yes to the question: "Do you believe that faith involvement with religion plays a significant role in managing money?" [47]

- Risk reduction

Fund managers employ several different tactics for the purpose of dealing with risk. The tactics employed are relative of the type and objective of the fund. Fund mangers also tend to manage risk by diversifying the accumulated cash in a variety of stocks, and this is one of the basis tenets of Modern Portfolio Theory. A well-diversified portfolio helps in decreasing the risk by offsetting losses from some stocks with gains in others. Some individual investors find it troublesome and expensive to build a portfolio as those constructed in the case of mutual equity funds. It is argued that mutual funds provide a feasible way for average investors to get the same sort of professional money management and diversification of investments that are available to large institutions and wealthy investors. [48]

- Investor Convenience

Mutual funds might be considered as a convenient way of investing especially for those market participants with limited financial capabilities. In certain funds, shareholders hold fifty or more individual stocks. The shareholder are meant not to be concerned with bookkeeping, tax records, and the sheet flows of paper associated with owning a diversified portfolio of many individual stocks. In addition, it might be difficult for an

47 Tanous, Peter (1999), The Wealth Equation, Prentice Hall Press-USA., p. 148.

48 See Pozen, Robert (1998), The Mutual Fund Business, The MIT Press, Massachusetts-USA.

investor with limited financial and investment experience to construct a portfolio in terms of placing an order, executing the order, transferring the shares, keeping track of dividends, etc. The fund management handles the latter duties, which is usually against a reasonable percentage of fees.

- Liquidity

It is argued that mutual equity funds are regarded as a liquid financial instrument. Investors in these funds are able to change investment requirements at any time; withdrawing or adding cash whenever necessary, aware that in specific type of funds some restrictions are applied. For instance, closed-ended funds are listed and tradable on stock exchanges, and redemption proceeds are usually available within a few days of presenting the redemption request.

(B) Religious rewards

The different sources of Islamic contract law clearly emphasise that income earned by Muslims must be *halal*. Muslims in the Day of Judgement are to be accounted of all of their acts including their spending and investments. According to the Quran:

> By no means shall you attain to righteousness until you spend (benevolently) out of what you love; and whatever thing you spend, Allah surely knows it. [49]

In order to ensure that Muslim investors are investing in mutual stock funds in a *halal* manner, they are required to go through a certain criteria. Initially, the investor is first required to check the operation of the targeted firm to ensure that it has nothing to do with *haram* (impermissible) matters e.g. alcoholic drinks, pornography, tobacco and pork.

49 The Quran: al-Imran [3:92].

Afterwards, the investor is obliged to employ a number of financial ratios in order to indicate the extent to which the targeted firm is involved in interest-rate based debt. However, in the case of Islamic Equity Funds, Muslims; especially those who lack the basics and the guidelines of Islamic investing, are not supposed to worry about any religious related problems. The fund manger, with the assistance provided by the members of *Shriaa* Supervisory Board, is supposed to only invest in Islamically valid stocks, and is also required to employ financial techniques that are inline with the basic tenets of Islamic contract law. Both these issues require expertise and specific skills - which some investors lack - and from this point Islamic Equity Funds gain advantage for Muslim investors.

Muslim investors, in certain instances, might prefer to invest in those Islamic Equity Funds that are accompanied with relatively low returns, rather than investing in "Islamically questioned" conventional mutual funds that are accompanied with higher returns. This is to avoid being involved in impermissible acts. Note that that Muslim investors do not have much choice when it comes to investing in *halal* funds, and hence, the current total number of Islamic Equity Funds is very limited when compared with other conventional equity funds. Muslims deem that they will be positively accounted for such trade-off at the Day of Judgement.

CHAPTER 4

THE QUESTION OF *GHARAR*

4.1 Overview

Saleh argues that the foundation of banning transactions that are associated with *gharar* in Islam is consistent with the notion of protecting the weak against exploitation by the strong.[1] Universally, Muslims believe that their religion sought to safeguard the interest of the weak party by ensuring that any transaction is supposed to be protected from uncertainty and speculation, and this can be accomplished by confirming that every party involved in a financial transaction possess sufficient information related to the particularities of the exchange e.g. price if not, the transaction is invalid due to *gharar*.

From this latter argument, *gharar* only occurs in situations in which one of the parties lacks sufficient information. However this begs a number of questions. Is this the only cause of *gharar*? The exploitation of the weak is not necessarily an outcome of the lack of sufficient information. What is the definition of *gharar*? What are the causes that lead to the emergence of *gharar* in a specific transaction? Why has *gharar* been banned in Islam although the Quran, through its comprehensive verses, did not refer to such a phrase at all? If that is the case, why did the Prophet and later on the four *fiqh* schools dedicate special emphasis to *gharar*? What has *gharar* to do with stock investing?

This part of the thesis attempts to touch all of these critical questions. Therefore, it is essential to go through the process by which *gharar* is banned in Islam, starting from

1 Saleh, Nabil (1992), Unlawful Gain and Legitimate Profit in Islamic Law, Graham & Trotman, UK., p. 62.

the Quran, and ending up by the stance of the current Muslim scholars on such a critical issue.

4.2 Stance of Quran and *Sunna* on *Gharar*

None of the broad verses in the Quran - the first source of Islamic contract law - refer to the phrase "*gharar*". Some argue that this might be one of the reasons that can be used as a justification of why the significance of *gharar* is less than to *riba*, noticing that *riba* has been mentioned in many different occasions in the Quran. Nevertheless, the additional three sources of Islamic contract law have successfully established some sort of relationship between *gharar* and gambling.

The Quran prohibition of gambling could be rationalised as a way of ensuring that getting something too easily or getting a profit without putting in a real and serious effort is impermissible.[2] Furthermore, it is interesting to note that the prohibition of gambling in the Quran has been accompanied with the involvement of intoxicant drinks. Both dealing with intoxicant drinks and gambling are considered to be great sins. This means that Muslims who drink wine or perform actions that are associated with gambling are to be punished in the Day of Judgement. The following three verses clarify the way the Quran dealt with the issue of gambling. According to the first verse, God mentions:

> O ye who believe! Intoxicants and gambling, (dedication of) stones, and divination by arrows, are an abomination of Satan's handiwork: eschew such (abomination), that ye may prosper. [3]

In the subsequent verse God mentions "Satan's plan is (but) to excite enmity and hatred between you, with intoxicants and gambling, and hinder you from the remembrance of Allah, and from prayer: will ye not then abstain? [4] In another verse, God mentions:

2 Saleh, Nabil (1992), Unlawful Gain and Legitimate Profit in Islamic Law, Graham & Trotman, UK., p.106.

3 The Quran: al-Ma'idah [5:90].

4 The Quran: al-Ma'idah [5:91].

> They ask thee concerning wine and gambling. Say: "In them is great sin, and some profit, for men; but the sin is greater than the profit." They ask thee how much they are to spend; say: "What is beyond your needs." Thus doth Allah make clear to you His Signs: in order that ye may consider.[5]

A number of issues can be drawn from the previous verses. First, in al-Baqarah [2:219], God mentions that there might be "some profits", but then assures that "the sin is greater than the profit". Second, in al-Ma'idah [5:90], God positions "gambling" side by side to "intoxicants" and at the end of the verses, God describes such acts as an abomination of Satan's handiwork. Thirdly, God in al-Ma'idah [5:91] provides the reason for banning "gambling" by stating that such a practice "hinders" Muslims from the remembrance of God.

The Sunna - which is based on the Prophet's acts, sayings and traditions - in certain *ahadiths* refers directly to *gharar.* On other occasions, the Prophet uses a number of exchangeable phrases. Muslim scholars have referred to these exchangeable phrases as a way of indicating *gharar*. For instance, there is a *hadith* that says:

> ... Selling fruit before it has begun to ripen is an uncertain transaction (gharar).[6]

On other occasions, the prophet refers to *gharar* in the sense of "uncertainty", or sometimes "gambling" or "*maysir*", and interestingly, by specifying one or more of its instances (e g. fish in the river, or birds in the air). For instance, in the following *hadith* the Prophet refers to *gharar* as a "game of chance". The *hadith* indicates that:

> .... The Prophet (peace_be_upon_him) forbade wine (khamr), game of chance (maysir), drum (kubah), and wine made from millet (ghubayrah), saying: Every intoxicant is forbidden.[7]

5 The Quran: al-Baqarah [2:219].

6 Sunan Abu Dawud, Book 31, No. 31.8.12.

7 Sunan Abu Dawud, Book 26, No. number 3677.

In another *hadith*, the Prophet says:

> Do not buy fish in the sea, for it is *gharar*. [8]

These *hadiths* portray a few transactions that are clearly involved with high speculation, such as selling fruits before they are ripe. The issue is that these fruits might not be ripen as the parties expect, and, hence, this leaves the transaction with uncertain outcomes. The other *hadith* "buying fish in sea" is even more uncertain, and the buy might not be realised at all.

Saleh illustrates the rationalisation that is employed by the *Sunna* in the process of banning *gharar*. He asserts:

> The rationale behind the prohibition of all of these sales is the fear of gharar (uncertainty; risk; speculation), whether in the ability of the vendor to deliver the object of the sale as in the case of the stray animal or in the existence of the subject-matter as in the case of milk still in the udders or agriculture products which have not yet come to fruition, or in the characteristics, such as the sale of the stones of the dates without the fruit, or in the date of the performance such as the sale of the young yet to be born. [9]

8 Ibn Hanabal, indicating that it's most correct version is handed down on the authority if Ibn Masu'd, not the Prophet. Cited from: Vogel, Frank, and Hayes, Samuel (1998), Islamic Law and Finance: Religion, Risk, and Return, Kluwer Law International, Massachuestts-USA., p.88.

9 Saleh, Nabil (1992), Unlawful Gain and Legitimate Profit in Islamic Law, Graham & Trotman, UK., p.106.

4.3 Islamic *Fiqh* Stance on *Gharar*

The four major *Fiqh* schools agree that *gharar* in Islam is banned. However, these schools do not quite agree on the definition and characteristics of the contract that might involve *gharar*. Vogel and Hayes attempt to summarise each school's explanation of *gharar*. The authors assert that the Hanafi and Shafii schools delineate that *ghrarar* occurs in that sales of non-existence objects or ignorance of the material aspects of the contract. The Maliki and Hanbali schools lean towards referring to *gharar* as gambling and degrees of risk. [10] El-Gamal refers to a number of definitions derived from Al-Zuhayli.[11] These definitions are quoted from Muslim scholars associated with the various *fiqh* schools. The following is a summary of these definitions:

- Al-Sarakhsi of the Hanafi school defined *gharar* as: "that whose consequence are hidden."
- Al-'Isnawi of the Shafi's school definition: "*gharar* is that which admits two possibilities, with the less desirable one being more likely."
- Ibn Taymiya of the Hanbali school's definition: "*gharar* is that whose consequences are unknown. His student Ibn Al-Qayyim said: it is that which is undeliverable, whether it exists or not."
- Ibn Hazm of the Zahiri school said: "*gharar* is where the buyer does not know what he bought, or the seller does not know what he sold."
- Al-Zuhayly's summary definition is: "*gharar* sale is any contract which incorporates a risk which affects one or more of the parties, and may result in loss of property."
- Al-Zarqa: "*gharar* is the sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling."[12]

Ibn Juzay [13]; a Muslim scholar who pertains to the Maliki school, identifies several cases and incidents whereby *gharar* might occur. These cases include:

- Difficulty in putting the buyer in possession of the subject-matter; such as the sale of stray animals ...

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10 Vogel, Frank, and Hayes, Samuel (1998), Islamic Law and finance: religion, Risk, and Return, Kluwer Law International, Massachusetts-USA, pp.91- 92.

11 Al-Zuhaylý, W. (1997), Al-Fiqh Al-'Islamy wa Adillatuh, Vol. 15, Fourth revised edition, Dar Al-Fikr, Damascus-Syria, pp. 2408-3411.

12 El-Gamal, Mahmoud (2000), An Economic Explication of the Prohibition of Gharar in Classical Islamic Jurisprudence, available at: http://www.ruf.rice.edu/elgamal, Internet, last accessed on 28/03/2001.

13 See: Ibn Juzay (1973), Qawanin al-ahkam al-shariyya, Dar al-ilm Lil-malayin, Vol 2, Beirut-Lebanon, pp. 148 and 172.

- Want of knowledge (*jahl*) with regard to the price or the subject –matter …
- Want of knowledge regarding the characteristics of the price of the subject Matter.
- Want of knowledge with regard to the quantum of the price or the quantity of the subject matter.
- Want of knowledge with regard to the date of future performance …
- Two sales in one transaction …
- The sale of what is not expected to revive ….
- *Bay al-hasah,* which is a type of sale whose outcome is determined by the throwing of stone
- *Bay munabadha*, which is a sale performed by the vendor throwing a cloth at the buyer and achieving the sale transaction without giving the buyer the opportunity for properly examining the object of the sale *Bay mulamasa,* where the bargain is struck by touching the object of the sale without examining it. [14]

It is concluded from these different cases that *gharar* is very broad. Starting from the lack of knowledge, then passing by the issue of two sales in one transaction, and then ending up with the two different types of *bay* (sale). Ibn Taymiyyah attempts to be more precise and successfully relates *gharar* to the degree of risk. Vogel and Hayes point out:

> Ibn Taymiyya argues that rendering the *gharar* rules as barring non-existence and lack of knowledge restricts contractual freedom too much, resulting in blind legalism and undue obstacles to people's welfare. *Gharar* is that which leads to the evils of *maysir* enumerated in the quran. Seeking to return *gharar* to the meaning of "risk", he renders it as which hesitates between soundness and destruction. "Sales of such *gharar* is prohibited since sales truly involve *maysir* or gambling. *Gharar* is a question of degree: uncertainly cannot be wholly eliminated from contracts, so if a contract involves minor gharar, it should stand.[15]

Analyzing these definitions and cases, it can be noticed that the most common characteristic among the majority of them pertains to the issue of "uncertainty". In other words, *gharar* is associated with uncertain outcomes. Now the question that follows is what degree of uncertainty invalidates a trade or a specific contract? The last definition presented by Al-Zarqa provides a

14 As cited in: Saleh, Nabil (1992), Unlawful Gain and Legitimate Profit in Islamic Law, Graham & Trotman, U.K., p.65.

15 Vogel, Frank, and Hayes, Samuel (1998), Islamic Law and Finance: Religion, Risk, and Return, Kluwer Law International, Massachusetts-USA, pp. 92-93.

clue to the answer. One of the interpretations that can be concluded from Al-Zarqa's definition is that once *gharar* makes a trade similar to gambling, the trade will be invalid. Hence, *gharar* becomes gambling when the outcome of the deal or contract involves significant uncertainty. Ibn Taymiyya employs the same latter argument, and argues that once a sale truly involves *maysir* or gambling, it is an invalid sale.

By employing both Ibn Taymiyya's and Al-Zarqa's arguments in the context of stock investing, it can be concluded that one of the indications that a stock might be associated with *gharar*, is that once the future outcome of investing in such a stock is significantly uncertain, and hence, the more the outcome is uncertain, the more the trade becomes a gamble.

4.4 Definition of Risk and Uncertainty From a Western Perspective

The terms "risk" and "uncertainty" have been extensively put to use in the different previously cited cases and definitions of *gharar*. Therefore, this part emphasises on these two important terms and this ultimately results in reaching a precise definition of *gharar* in terms of stock investing.

Cassell asserts that for various individuals, prior experiences, media exposure or influences of colleagues shape the image of risk.[16] To the general population, risk can be classified as 'high, medium or low risk'. These classifications can by measured by certain statistical measures. In a similar context, investment risk can be measured by the variability of the investment's returns.

According to the Oxford English Dictionary, risk is defined as "to expose to the chance of injury or loss." [17] There are also several other definitions of risk e.g.: uncertainty, the chance of loss, the probability of any outcome different from the one expected, the dispersion of actual from expected results and the possibility of loss. MacCrimmon and Donald relate to risk loss, the authors point out that there are three components of risk: magnitude of loss, the chance of loss and the exposure to loss. And in order to reduce risk, it is necessary to reduce at least one of these components.[18] Weston relates risk to the future outcome, and this outcome might be loss or profit, in other words risk is not limited to loss. The author illustrates that risk

16 Cassell, Merrill (1999), Risk and Return, Management Accounting, Vol, 77, Issue 9, pp. 22-25.

17 Oxford on line dictionary, available at: http://dictionary.oed.com/, Internet, last accessed at 29/03/2001.

18 See MacCrimmon, Kenneth and Wehrung, Donald (1986), Taking Risks, The Free Press, USA.

is the chances of receiving an actual return other than expected, which simply means variability in the returns or outcomes from the investment. [19]

Vaughan illustrates that there are two common elements in all the definitions of risk. First, the notion of an intermediate outcome is implicit in all definitions of risk, in other words the outcome must be in question. Second, at least one of the possible outcomes is undesirable. [20] Value investors define risk distinctly; the thrust of their definition is "intrinsic value". For instance, Buffett, a great believer of value investing, defines risk as the possibility of harm and injury. Buffett gives special attention to the so called "intrinsic value risk" of the business, and not the price behaviour of the stock. Real risk in the eyes of Buffett is whether after-tax returns from an investment give the investor at least as much purchasing power as he had to begin with, in addition to a modest rate of interest on that initial stake.[21]

In certain literature, the words "risk" and "uncertainty" are used interchangeably, even though technically, their meanings are different. Klein asserts the following:

> In talking about uncertainty, people tend to mix many things together. A review of the literature shows that people discuss uncertainty in terms of risks, probabilities, confidence, ambiguity, inconsistency, instability, confusions, and complexity. They refer to uncertainty about future states, the nature of situation, the consequences of actions, and preferences. [22]

Fischer suggests that in the case of risk, the decision-maker recognises the possible consequences of a decision and their relative likelihood at the time the investor makes

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19 Weston, Fred and others (1996), Essentials of Managerial Finance, The Dryden Press, USA.

20 SeeVaughan, Emmett (1999), Fundamentals of Risk and Insurance, John Wiley & Sons, Inc.

21 See Cunningham, Lawrence A. (2001), How to Think Like Benjamin Graham and Invest Like Warren Buffett, McGraw-Hill Professional Publishing.

22 Klein, Gary (1998), Sources of Power: How People Make Decisions, MIT Press, MA-USA, p. 277.

that decision. On the other hand, uncertainty involves a situation about which the likelihood of the possible outcomes is not known.[23]

Edgar argues that the studying of "economic uncertainty" is divided into two schools: the "mainstream" (Keynesian) school and the "subjective" school. [24] The former school defines uncertainty in the same manner as probabilities; that is, uncertainty can be measured by assessing the probabilities, the associated risk and the benefits (or utility) of all the possible outcomes. People make decisions based on the trade-off of the risks and returns associated with these probabilities. On the other hand, the subjective school defines uncertainty as prediction that is at best chancy and at worst impossible. Such a school believes that uncertainty - as a part of the nature of free markets- cannot be eliminated. Hence free markets are too complex for models and predictions. The author also illustrates the duty of Western economics is limited to understanding how free agents, pursuing their own interests, can spontaneously organise into a coherent economic entity. [25]

According to Vaughan, the most widely held meaning of uncertainty is characterised by doubt, based on lack of knowledge about what will or what will not occur in the future. It is the opposite of certainty, which is in a way an assurance or certitude about a specific situation. [26] Edgar emphasises that uncertainty is not the same as risk, simply because there may not be a "loss" involved. Therefore, the uncertainty is not "risk" in the probability sense. It can be useful or not, but it is not necessarily bad. [27]

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23 Fischer, Donald E (1995), Security Analysis and Portfolio Management, Prentice-Hall Inc., p.70.

24 Peter, Edgar E., (1999), Patterns in the Dark: Understanding Risk and Financial Crisis with Complexity Theory, John Wiley & Sons, Inc.

25 Ibid., p.63.

26 Vaughan, Emmett (1999), Fundamentals of Risk and Insurance, John Wiley & Sons, Inc. , p..3.

27 Peter, Edgar E., (1999), Patterns in the Dark: Understanding Risk and Financial Crisis with Complexity Theory, John Wiley & Sons, Inc.

Last not the least, it is worth highlighting Jehle's attempt to bring together both terms; "risk" and "uncertainty", in an effective manner. The author illustrates that "We structure the uncertainty facing an agent by interpreting risky situations as gambles."[28]

It is worth noting that the "risk versus uncertainty" debate is long-running and not yet resolved. By reviewing some of the available literature on risk and uncertainty, it can be observed that scholars pertaining to different schools of thought disagree on the definition and characteristics of the latter both terms. Note that the researcher in this section has attempted to clarify how the different schools defined risk and uncertainty in order to set a concrete foundation for defining *gharar* in the context of stock investing.

28 Jehle, G. A. (1991) Advanced Microeconomic Theory, Prentice Hall, USA., p. 193.

4.5 Suggested Definition of *Gharar:*

After exploring the stance of the different sources of Islamic contract law on *gharar*, and identifying the commonalties and differences between "risk" and "uncertainty" especially from a Western perspective, it is time to come up with a suggested definition of *gharar* in the context of stock investing. Based on the literature review that has been already performed, it appears that none of the scholars suggested such definitions especially in the context of stock investing. It is also observed that there is no unified definition of *gharar* on which the different sources of Islamic contract law agree. On the contrary, there is a clear discrepancy regarding the way the various sources of Islamic contract law define *gharar*. These two issues add complexity to the issue of reaching a definition of *gharar* in the context of stock investing.

The affect of *gharar* can certainly extend to modern transactions, one of these transactions is investing in the different securities (precisely stocks) that are tradable in the stock market. A Muslim scholar asserts the following:

> Far from having its scope narrowed by a change of circumstances, the question of *gharar* pervades a number of contemporary operations which were not contemplated or at any rate not common during the Prophet's time. This is to say that transactions and contracts relating to insurance and assurance, to life annuity, to the stock exchange market and generally speaking all sorts of transactions where the subject matter, the price or both, are not determined and fixed in advance, are under a suspicion of *gharar* according to *shariaa* standards.[29]

One of the key questions the thesis attempts to answer is how can *gharar* be correlated with stock investing? To be able to answer this question, there is a need to proceed in tackling a number of the following questions: (1) Which aspect and part of the process of stock investing might be affected by *gharar*? (2) Is the past and future

29 Saleh, Nabil (1992), Unlawful Gain and Legitimate Profit in Islamic Law, Graham & Trotman, UK., pp. 62-63.

price attitude of a specific stock an indication of the presence of *gharar*? (3) Or it might be that *gharar* - affect is dependent on the behaviour of those stock traders? (4) If that is the case, what about day traders and the extent to which they are involved with *gharar*? (5) What about those traders who trade stocks without assessing the risk and the real value of a particular firm?

Al-Dhareer is one of the very few Muslim scholars able to establish a concrete relationship between *gharar* and a financial contract. The author lists four necessary conditions for *gharar* to invalidate a contract. First, *gharar* must be major. Second, the potentially affected contract must be a financial contract. Third, *gharar* must affect the principal components of the contract (e.g. the price and object of sale, language of the contract, etc.). Fourth, there is no need met by the contract containing *gharar*, which cannot be met otherwise. Al-Dhareer's conceptual definition of *gharar* is fairly well specified, and to some extent adequate to judge the degree of *gharar* required to validate (or invalidate) a financial transaction. Based on Al-Dhareer's description of *gharar*, once it can be said that a stock purchase or sell transaction (as a sort of financial contract) becomes invalid if the transaction involve major *gharar*, and this *gharar* affects the price of the stock.

The foundation of the succeeding proposed definition of *gharar*, is built on the following four blocks: (1) Al-Dhareer's description of *gharar*, (2) Ibn Taymiyyah's opinion on *gharar*, (3) Al-Zarqa's definition of *gharar*, and (4) Jehle's proposed definition of uncertainty in terms of risk. The outcome of connecting these blocks with each other is the following definition of *gharar*. *Gharar,* in terms of stock investing, is defined as "the avoidable risk resulting from transactions associated with significant and unnecessary uncertain outcomes."

It can be observed from the latter definition, that *gharar* has been defined in terms of "risk", and this is a central issue. Among one of the forthcoming chapters, an attempt is made to employ the different conventional valuation tactics such as beta and Price Multiples ratios as sufficient indicators of *gharar*, and this requires defining *gharar* in terms of risk. It is worth indicating that "unavoidable" type of risk is beyond the control of the stock market participant, and most probably the participant is unable to eliminate or even confront such type of risk. The Modern Portfolio Theory suggests two types of risks: - systematic and non-systematic. As for systematic risk, it is defined as the risks that are associated with market dynamics that are beyond the control of the investor. In regard to unsystematic risk, it refers to the risk associated with the firm's operations. The central issue is that the investor can deal with this type of risk, and this can be achieved by employing several tactics e.g. diversification. Assuming that the investor is not attempting to reduce such type of risk, he might be involved in *gharar*. It should be noted that the concepts of "systematic" and "unsystematic" risk are narrower that these of "avoidable" and "non-avoidable" risk employed in this thesis.

The definition of *gharar* is not only limited to avoidable risk, since significant uncertainty is also a central issue. The word significant is defined as of "a noticeably or measurably large amount"[30]. It is also defined as "fairly large in amount or

30 Merriam's Webster Online Dictionary, available at: http://www.m-w.com/cgi-bin/dictionary, Internet, last accessed at 25/07/2001.

quantity"[31]. The focus here is on "significant" uncertainty, because it may be permissible to accept some degree of uncertainty. In contrast, a certain degree of uncertainty might be found in a number of Islamic finance techniques. For instance, *musharaka* and *mudaraba* contracts consist of a certain limit of uncertainty. These two contracts are based on the idea that the involved parties are obliged to share any expected profits or loss, which are both uncertain outcomes to a certain extent.

The purpose behind referring *gharar* to significant uncertain outcomes is to separate outcomes that are associated with gambling from those outcomes that are not associated with gambling. Hence one of the end results of prohibiting gambling in the different sources of Islamic contract law is due to the existence of social harms. In other words, acts and games associated with gambling usually involve some sort of exploitation, because whatever gain a gambler may make out of gambling or other chance games would be based on the losses of other people. The end result, the definition of *gharar* is referred back to its origins, which is gambling, as mentioned in the Quran. Vogel and Hayes attempt to analyse the several *hadiths* related to *gharar*, the authors assert the following:

> Another reading of the *hadiths* is possible, one which starts from the Quranic prohibition of *maysir*, which mentions as its reasons only enmity and distraction from religion. These reasons resemble the grounds on which many societies prohibit gambling contracts, that gambling leads to individual immorality (the compulsion to gamble) and to social harms.[32]

It is also important to characterise uncertain outcomes with the term "unnecessary". This term again eliminates the stock market participants to engage in acts and

31 Merriam's Webster Online Dictionary, available at: http://www.m-w.com/cgi-bin/dictionary, Internet, last accessed at 25/07/2001.

32 Vogel, Frank, and Hayes, Samuel (1998), Islamic Law and Finance: Religion, Risk, and Return, Kluwer Law International, Massachusetts-USA, pp. 90.

transactions associated with unnecessary uncertainty e.g. gambling. Hence, the risk associated with transactions involving gambling usually involves unnecessary risk and uncertainty. Having said that, it is worth indicating that there are particular situations where by Muslims are permitted to take part into transactions and financial contracts that involve in someway "significant risk". These contracts include: *salam*[33], *istisna*[34], and *bay al arbon*[35]. The justification of permitting such contracts refers to "necessity". In Islam, necessity is connected with the "Objectives of Islamic Law"(*maqasid al-shariaa*); a central concept that Muslim scholars excessively refer to in their writings. This concept can be employed to explore the permissibility of contemporary issues. This concept is very similar to "cost-benefit" analysis. [36]

Having said that, it is worth indicating that certain *fiqh* schools refer *gharar*, at least in a direct manner, to one of the following positions: (1) non-existence of the product, (2) ignorance of any material aspect of the transaction. Though, in the eyes of the researcher of this thesis, Muslim market participants are obliged to avoid financial transactions associated with destructive type of outcomes such as trading acts that leave a negative impact on the economy by increasing the volatility of stock markets. Hence, the researcher believes that the justification of this obligation is not due to *gharar* avoidance rather than due to the issue of justice. Aware that the different sources of Islamic contract law clearly emphasise the importance of being "just" while performing daily activities. Chapra asserts that:

> Islam wishes to eradicate from human society al traces of *zulm*, which is a comprehensive Islamic term referring to all forms of inequity, injustice,

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33 *Salam*: a contract where a cash purchase of a product is performed in advance, against a future delivery. The date and product specification must be pre-agreed.

34 *Istisna*: a contract where the purchaser orders a specific product from the manufacturer, to be delivered on a specified date.

35 *Bay al arbon* : a partial payment (returnable) paid by a buyer retaining the right to pursue or reject a sale occurring in the future.

36 See El-Gamal, Mahmoud (2000), An Economic Explication of the Prohibition of Gharar in Classical Islamic Jurisprudence, Available at:http://www.ruf.rice.edu/elgamal, Internet, accessed on 01/04/200, p.9.

exploitation, oppression and wrongdoing, whereby by a person either deprives others of their rights or does not fulfil his obligation towards them.[37]

An example on this argument is the case of insider trading. The National Association of Criminal Defence Lawyers (NACDL) of the USA mentions the following:

> Reversing a decision by the Eighth Circuit Court of Appeals, the High Court in United States v. O'Hagan1 approved the "misappropriation theory" as a prosecutorial tool against insider trading in criminal and civil insider trading cases. ... The misappropriation theory subjects individuals who trade on material, non-public information to prosecution, regardless of whether they worked for the company whose stock was being traded or otherwise owed the corporation's shareholders a fiduciary duty.[38]

In the case of insider trading, the market participant is aware of information that is not available to the rest of the public due to particular reasons. Consequently, the market participant bases his trades on the unique information he owns. It must be noted that the different sources of Islamic contract law clearly take a firm stance on all forms of bartering that involve cheating, or deception, and all other financial transactions that may entail injustice to one of the two parties. Accordingly the prohibition of insider trading is resolved by law (civil or Islamic contract law) which is due to justice and fairness concerns rather than due to the issue of *gharar*.

In short, the author of the thesis tends to focus on the views of very famous scholar Ibn Taymiyya; which tends to refer to *gharar* as the degree of risk that leads to the evils of gambling. Two scholars assert the following lines on Ibn Taymiyya:

> ... who in magisterial treatises sought to refashion *fiqh* contract law. Although his influence on later can be traced, his unique positions usually found favour only with his students, foremost among these Ibn al-Qayyim. Moderns, however, find Ibn Taymiyya's positions more congenial to modern law than those of other classical scholars, and have given his views vast new currency.[39]

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37 Chapra, Umer (1985), Towards a Just Monetary System, The Islamic Foundation, U.K., pp. 27-28.

38 National Association of Criminal Defense Lawyers (NACDL), available at: www.nacdl.org/CHAMPION/ARTICLES/97dec04.htm, Internet, last accessed at 26/07/2001.

39 Vogel, Frank, and Hayes, Samuel (1998), Islamic Law and Finance: Religion, Risk, and Return, Kluwer Law International, Massachusetts-USA, pp. 92-93.

4.6 Speculation, Gambling and the Question of *Gharar*

The purpose of this section is to identify the relation between speculation, gambling and *gharar*. And this also requires tackling "risk", since the previously proposed definition of *gharar* has been in terms of risk.

Many participants in the stock market tend to speculate while making a decision to trade a certain stock. They will buy stocks on the hope that their prices will increase in the future and consequently they will earn income through either capital gains or dividends. However, the degree of speculation differs from one participant to another. It all depends on the participant's objective and the extent to which he or she is ready to face a certain degree of risk.

The amount of risk differs from one type of investment to another. Furthermore, investors react differently to the risk that they are faced with. There are investors who only accept low to relatively medium degrees of risk. These investors may desire to achieve long-term goals e.g. college tuition for their children, or economic security in retirement. Such investors believe that the best way of accomplishing their targets is through long-term capital appreciation. The sources of capital appreciation are usually the earnings and dividends of investing in a specific stock. Buying stocks for long-term periods is one of the major characteristics of so called "value investors".

One other hand, there are participants in the stock market that intend to maximise their gains by focusing on the short-term price movements of stock prices. For these traders, volatile stocks are the best fit. In certain occasions, these traders are referred to as "gamblers". It is said that the investor is more concerned with reducing specific type of risks e.g. unsystematic risk, while the gambler is more involved in risk-taking.[40]

Moynihan identifies how the late Austrian economist Ludwig Vow Mises discriminated between the three ways of dealing with the future. The dealings suggested by the author include: gambling, engineering and speculating, and the description of each them is as follows:

> Gamblers know nothing about the event on which the outcome of their gambling depends; they simply trust their luck. Engineers, on the other hand, know everything they need to know to arrive a technologically satisfactory answer to the problem they face. Speculators when facing their own special form of uncertainty, know more than gamblers but less than engineers.[41]

The classification suggested by Vow Mises - although the author's focus is on discriminating between the three ways of dealing with the future - can be utilised to draw a line between the different participants in stock markets. Especially once the word "engineers" is replaced with "investors", since both of them share similar characteristics. The author describes "engineers" as those who know everything they need to know to arrive to a technologically satisfactory answer to the problem they face. By modifying the author's own words into investment and finance, it can be concluded that investors are also those that are aware of the fundamentals of the firm they tend to invest in. And this awareness is a result of identifying the expected return, and the risk that the return that is achieved will be less than the return that was expected.

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40 See Fischer, Donald E (1995), Security Analysis and Portfolio Management, Prentice-Hall Inc.

41 Moynihan, Brendan (1997), Trading on Expectations: Strategies to Pinpoint Trading Ranges, Trends, and Reversals, John Wiley & Sons, Inc, p.112.

It is observed that the assessment of risk involves some sort of speculation, in the sense that the investor needs to speculate the expected returns that the firm might generate. It is in this stage where the importance of speculation on stock investing emerges. The following lines attempt to deal with such issue.

While defining risk, many books provide examples of the different probabilities resulting from flipping coins, rolling dice or other games that are built on pure chance. It is concluded that the common matter among the previous types of games is that outcome is either win or lose. Al-Suwailem illustrates that these games are not as remote from the practical outcomes investors make when they invest in stock markets. However, in some occasions investing in stocks might turn into gambling even though the outcome is not win or lose, as is the case in gambling games. Al-Suwailem points out: "In many respects, stock markets are viewed as gambling casinos ... many practices in these markets are considered *gharar*, and therefore bear strong resemblance to gambling." [42] In strict view, gambling in stock markets can be considered as a zero-sum game, however if the market as a whole is rising (or falling) this may be the appearance of non zero-sum game characteristics. Yet, at a certain time, the zero-sum aspects will be present.

On the other hand, El-Ashkar points out that speculation in stock markets cannot be equated to gambling.[43] He describes speculation as the practice of utilizing available information to predict future price movements of securities. In addition, the author clarifies that speculating in financial markets is different when compared to gambling

42 Al-Suwailem, Sami (2000), Towards an Objective Measures of Gharar in Exchange, Islamic Economic Studies, Vol. 7, No. 1 & 2, p.80.

43 El-Ashkar A. AF, (1995), Towards an Islamic Stock Exchange in a Transition Stage, Islamic Economics Studies, Vol. 3, Issue 1, pp. 79-114.

on the results of the turn of a card or casting of a dice. Conversely, speculation is a process dependent on different types of analysis, mainly fundamental analysis.

Niederhoffer cites that one of the main differences between gambling and speculation is that the risk of gambling is created by the "casino" for entertainment, whereas the risk of speculation is inherent.[44] The speculator's actions lead to a risk transference as well as a finding the price that balances between what is desired against what is available in quantity, quality, and time. The author illustrates that the gambler receives entertainment and a "prayer" for gain in return for his hard-earned dollars!

The view of the great economist Keynes[45] on the difference between speculation and investment is one of the most logical ones. Investment in the eyes of Keynes is an activity that is associated with predicting and forecasting. The investor attempts to predict the yield on assets over the life of the asset. On the other hand, even though Keynes assures that "speculation" is also based on forecasting and predicting the market, the prediction is limited to the psychology of the market.

Value investing thinkers such like Graham and Buffett, have taken a turn at explaining the differences between investment and speculation. Graham's point of view is centred around the following idea: in order to confirm safety of principle and a satisfactory return, there must some sort of analysis, and once such analysis is missing, the investor becomes a speculator.[46] Buffett employs different parameters for separating speculation from investment. He asserts that investors give special

44 See Niederhoffer, Victor (1997), The Education of a Speculator, John Wiley & Sons.

45 See Keynes, John (1964), The General Theory of Employment, Interest, and Money Harcourt Brace & Company, Orlando-USA.

46 See Garaham, Dodd and Graham Benjamin (1934), Security Analysis, McGraw-Hill.

emphasis on future prospects of the business, however, the primary focus of speculators is limited to forecasting the price the stock will reach independent of the business.[47]

In most cases "gamblers" share certain characteristics that distinguish them from others. These characteristics include: the odds are undesirable, the behaviour is risk seeking, and an unsystematic approach is being performed.[48] These characteristics also include: an emotion such as greed and fear, the activity is a discrete event or series of discrete events and not part of a long-term plan, and most important no net economic benefit results.[49] Another characteristic that distinguishes a gambler in the case of stock markets, is the total number of trades that are performed in a very short-term basis. It can be argued that for the sake of achieving high and quick profits, the gambler performs a high number of trades during a very limited period of time, such participants are referred to as "day traders". According to the US based Securities Industry Foundation for Economic Education, the definition of "day trading" is:

> ... the frequent buying and selling of stocks during a day in an effort to gain from rapid and often tiny changes in their prices. Day traders often hold a stock for seconds and minutes, and most sell all the stock purchase by the end of the day.[50]

Tia argues that day traders are increasingly affecting the stock market's performance.[51] In the author's eyes, day traders are best described as those who wrap up their transactions by the end of each session.[52] Day traders are little concerned with

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47 Emerson, Henry (1997), Outstanding Investor Digest, August 8, p.14.

48 Investor Words web site, available at: http://investorwords.com/, Internet, last accessed on 01/04/2001.

49 Ibid.

50 Securities Industry Foundation for Economic Education (SIFEE), available from http://www.sec.gov/investor/pubs/daytips.htm, Internet, last accessed on 01/04/2001.

51 Brien, Tia (2000), The Day Trader Blues, Upside (U.S. edition). Jan, Vol. 12, Issue. 1, Foster City- USA., p. 182 (182-192).

52 Ibid., p. 182.

the real true value of the underlying firm. Their concerns are more focused towards forecasting and predicting the current and future sentiment. Schapiro attests that day trading is:

> .... a risky, speculative activity and even the most experienced day traders may suffer severe and unexpected financial losses, even beyond their initial investment. [53]

In recent years, day traders gained more strength in light of the introduction of technology into stock trading. The advent of computerised trading, including the Internet and electronic communication networks, along with the Securities and Exchange Commission's Film Quote and Display Rules, have equalised the opportunities for market participation, but also permitted specific type of traders to use in a negative manner e.g. by trying to benefit from volatility of stock prices in short periods.

Ahead of placing cash in stocks, market participants perform different types of analysis. For instance, value investors employ different ratios and tactics that are derived from fundamental analysis. In contrast, gamblers or speculators or day traders primarily execute technical analysis. Brandes undertakes a firm stand against traders who employ technical analysis, and assures that focusing on the price behaviour has never served adequately as a substitute for fundamental analysis. [54] The author backs up his argument with several evidences. Alexander describes the main difference between those who perform fundamental analysis (known as fundamental analysts or fundamentalists) and those using technical analysis (known as technical analysts or technicians). The author asserts that:

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53 Sachapiro, Mary,(1999), Testimony on the Securities Day Trading Industry, before the Permanent Subcmmittee on Investigations, Senate Committee on General Affairs, Sep, available at. http://www.sec.gov/investor/pubs/daytips.htm, Internet, last accessed 01/04/2001.

54 See Brandes, Charles (1997), Value Investing Today, McGraw-Hill.

> The fundamentalist tends to look forward: the technician backward. The fundamentalist is concerned with such things as future earnings and dividends, while the technicians thinks little (if at all) about such things.[55]

Furthermore, the author argues that the concept of technical analysis contradicts the notion of efficient markets. The methodology of technical analysis is based on the assumption that history tends to repeat itself in the stock exchange. Malkiel mentions that one of the central issues in technical analysis is that all financial information such as earnings, dividends, and the future performance of a firm is automatically translated in the firm's past market prices. [56] It should be emphasised, that a large part of the methodology of technical analysis lacks a concrete logical explanation. Graham stated so well more than 50 years ago:

> A moment's thought will show that there can be no such thing as a scientific prediction of economic events under human control. The very "dependability" of such a prediction will cause human actions which will invalidate it. Hence thoughtful chartist admit that continued success is dependent upon keeping a successful method known to only a few people.[57]

Fundamental analysis has also its own flaws. First, there is a possibility that the information and analysis, which are under the spotlight, is false. Second, the security analyst's and other investment professional estimates of the future value might be imperfect. Third, the market may correct its direction and the stock price might not converge to its estimated value.[58]

Malkiel provides his own explanation behind why trends in the case of technical analysis might tend to perpetuate themselves. The first reason is that the crowd instinct of mass psychology makes market trends repeat its self. Secondly, the author

55 Alexander, Gordan J (1993). Fundamentals of Investments, Prentice-Hall Inc., p.352.

56 Malkiel, Burton (1995), A Random Walk Down Wall Street; Including a Life-cycle Guide to Personal Investing, W. W. Norton & Company, Inc., USA., p.118.

57 Garaham, Dodd and Graham Benjamin (1934), Security Analysis, McGraw-Hill. p.619.

58 Malkiel, Burton (1995), A Random Walk Down Wall Street; Including a Life-cycle Guide to Personal Investing, W. W. Norton & Company, Inc., p.132.

illustrates that there may be unequal access to fundamental information about a firm. And on an occasional basis, a favourable sort of news occurs and the insiders are the first to know, as a result they buy the stock causing a rise in stock prices. The insiders then tell their friends, who act next. Then professionals receive the news and large institutions get a share of the firm's stocks. Finally, the average individual investor gets hold of the news and starts buying the stock, even though it might be too late. All the latter transactions cause the price of the stock to increase gradually. In the case of bad news, the same "grapevine" process occurs, however the price decreases. [59]

Malkiel also brings up a number of reasons that might lead to the failure of technical analysis. First, the chartist buys in only after price trends have been recognised, and sells after the price trend has been broken. More often, the chartist misses the appropriate signal, since sharp reversals in the market may happen with no warning. Second, once the majority traders that apply technical analysis act on simultaneously, then no buy and sell signals can be worthwhile. Moreover, if it was ever profitable to employ technical analysis, it will be possible only for those who are able to forecast signals. Third, prices may adjust so quickly to new information as to make the whole process of technical analysis a futile exercise. [60]

There is no doubt that investing in stocks is accompanied with some sort of speculation. In the previous sections has been shown that participants in the stock market might be distinguished from each other on the basis of the style and objective

59 Malkiel, Burton (1995), A Random Walk Down Wall Street; Including a Life-cycle Guide to Personal Investing, W. W. Norton & Company, Inc. pp. 125-126.

60 Ibid., pp.126-127.

61 Metwally, M (1997), Economic consequences of applying Islamic principles in Muslim societies, International Journal of Social Economics, Vol. 24, No. 7/8/9, MCB University Press, p. 944 (941-957).

of each one of them. There are participants who perform fundamental analysis and others who perform technical analysis. In addition, there are participants who tend to invest in stocks for very short-term periods for the purpose of achieving fast profits, and the same time, there are those who tend to invest in firms for long-term purposes.

The researcher believes that there is nothing wrong with technical analysis especially when it is used beside fundamental analysis for the purpose of quantifying the real value of a potential firm. However the problem arises once the stock market participant becomes fully dependent on technical analysis and discards any other type of analysis. Technical analysis becomes undesirable when it fuels the instability of the stock market due to high speculative activities, and this ultimately causes harm to other stock market participants.

Metwally asserts that the types of speculation that are banned in Islam doctrines include races, games of cards and other (conventional) gambling activities.[61] The author becomes more precise by mentioning the implications of the activities that are associated with high speculation and *gharar*. The implications include:

- No savings will be directed (through the prohibited types of speculation) towards holding assets with the intention of making capital gains. Thus, if savings were to be activated at all, they would be directed towards real investment.
- There would exist no basis for "liquidity preference" for the speculative motive. The demand for money for speculative purposes, in the Kenesian sense, is non-existent.
- The expected rates of return on investment (or the marginal efficiency of capital) will not exhibit the typical short-run instability caused by the speculative activity in capital markets. [62]

62 Metwally, M (1997), Economic consequences of applying Islamic principles in Muslim societies, International Journal of Social Economics, Vol. 24, No. 7/8/9, MCB University Press, p. 944 (941-957).

El-Gamal suggests applying "cost-benefit" analysis for the purpose of distinguishing between the permission and prohibition of a contract, which embodies *gharar*. The author also points out that the injunction against "trading in risk or *gharar*" can be explained based on more subtle considerations of economic inefficiency arising from the mis-pricing of risk. [63] Hence, speculators and gamblers leave a negative impact on the economy especially in the long-term. In the aggregate, rapid trading hurts the performance of individual portfolios. It can also act as an economic drag because it causes money to be misallocated and siphoned out the entire productivity, and corporate earnings get wasted on commissions and costs related to frivolous trading.[64] Shiller, in his recently published book "Irrational Exuberance", emphasises that stock prices has been too high to be rationalised by fundamentals, and that the markets are exposed to heightened volatility when they are severely overextended. Throughout the different chapters of the book, the author clarifies the causes behind the presence of volatility in stock markets. One of these causes is the rise of gambling opportunities. [65]

63 El-Gamal, Mahmoud (2000), An Economic Explication of the Prohibition of Gharar in Classical Islamic Jurisprudence, available at: http://www.ruf.rice.edu/elgamal, Internet, last accessed on 01/04/2001.

64 Vick, Timothy (2000),How to Pick Stocks Like Warren Buffet, McGraw-Hill, p.80.

65 See Shiller, Robert (2000), Irrational Exuberance, Princeton University Press, Princeton-USA.

4.7 Summary

The significance of this chapter is resulted from being able to suggest a definition for *gharar* in terms of stock investing. The foundation of this definition is based on the different sources of Islamic contract law. The definition consists of two major aspects: (1) *Gharar* is restricted to avoidable (non-systematic) risk. (2) In order for *gharar* to invalidate a contract, the future uncertain outcome must be significant and unnecessary.

A relation between the different stock market participants (investors, speculators and gamblers) and *gharar* has been established. It is observed that the degree of *gharar* increases in the cases of speculators and gamblers. In addition, those market participants that base their trades on pure speculation such as day traders might be also involved in *gharar*. Last not the least, while assessing *gharar*, it is essential to scrutinise the implications resulting from it on the economy, and this requires referring to the "Objectives of Islamic Law"(*maqasid al-shariaa*), since in few cases, *gharar* might be justified.

CHAPTER 5

SCREENING CRITEIRA OF ISLAMIC EQUITY FUNDS AND INDEXES

5.1 Overview

This chapter is divided into four main parts. The first part provides a general overview on the screening criteria of value-based equity funds e.g. social, environmental and Islamic funds. The second part highlights the basics and fundamentals of the screening criteria of Islamic Equity Funds. Part three explores the general screening strategies employed by value-based mutual equity funds, a special emphasises is given to the screening criteria of Islamic Equity Funds. The fourth part presents a sample of screens of Islamic Equity Funds and Indexes in order to verify the main aspects these screens cover. In addition, it is hoped that studying the selected sample will result in indicating if *gharar* is being included in these screens or not.

5.2 Screening Criteria of Both Islamic Equity Funds and Ethically Based Funds

In the case of mutual equity funds, fund managers prior to taking a decision to purchase, hold or sell might apply some sort of screen(s). This "screen" can be described as a "criterion" applied on a universe of potential stocks for the purpose of dividing desirable stocks from non-desirable ones. [1] These screens differ from one fund to another, the issue depends on the type and objectives of each fund. The are mainly two types of screens: "financial" and "non-financial". Essentially, "financial screens" are based on quantitative analysis. Perhaps the most common financial screen in the case of stocks is the "earnings multiple ratio"[2]. A non-financial screen is usually more concerned with qualitative type of analysis. In addition, non- financial screens could take different types depending on the concept or philosophy behind the screen. For instance, in the case of social equity funds, the type of screen employed is called " social screen", which is designed to meet the expression of an investor's social and ethical concerns. Market participants who employ social screens avoid investing in firms involved in businesses that contradict the values behind such type of screen. For instance social screens avoid investing in alcoholic beverage manufacturers and any other firms involved in the nuclear power, gaming, and military weapons businesses. In the case of environmental equity funds, the supporters of this type of funds employ an "environmental screen". The purpose behind the environmental screen is "screening out" firms that pollute the environment. There are other screens that are similar to the latter two types that fall into several different classifications such as community relations, product quality and safety, labor/employee

1 Domini, Ami and Kinder Peter (1997), Social Screening: Paradigms Old and New, Journal of Investing., Winter, Vol. 6, Issue 4, New York-USA., .pp.12-19.

2 This ratio is employed to determine if a stock is under or over valued. It equals the stock price (capitalization) divided by its net earnings.

relations and offshore operations. Hence, all these different categories employ qualitative screens. [3]

It is interesting to note that earliest social screens disqualified investments in firms that are involved in military weapons, alcoholic beverages, tobacco products, and slaves. The foundation of excluding these types of businesses is based on religious concerns and principles. And that was the case of screening criteria of social funds until the early days of the twentieth century, in which social screens evolved into "secular dogma". [4] Domini and Kinder assert that "gambling" was only included in the social screen until the 1960s because very few publicly traded firms had casinos or racetracks.[5] Also in light of the advances that occurred in the medical science, Roman Catholics and other similar religious groups have clearly opposed abortion and birth control related issues. Consequently, hospitals that provide such medical services are excluded by the social screens. Today, social and environmental screens are much more comprehensive. These screens are not only restricted to tobacco and alcoholic issues, but include issues such as "diversity in the workforce", "women in upper management positions" and "human rights policies". [6] In the U.K, there are particular types of funds called "ethical" funds and "green" funds. Both of these funds employ very similar screens to those employed in the case of "social" and "environmental" which are familiar in the U.S. [7] Other Western

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3 Domini, Ami and Kinder Peter (1997), Social Screening: Paradigms Old and New, Journal of Investing,, Winter, Vol. 6, Issue 4, New York-USA., .pp.12-19.

4 Domini, Ami and Kinder Peter (1997), Social Screening: Paradigms Old and New, Journal of Investing, Winter, Vol. 6, Issue 4, New York-USA., .pp.12-19.

5 Ibid.

6 CNN Financial News, available at: http://cnnfn.cnn.com/1999/03/26/investing/q_social/, Internet, last accessed at 16/4/2001.

7 Canham, Jacqui, Screening for Green Investment, Financial Times On ILne Edition, available at: http://globalarchive.ft.com/globalarchive/articles.html?id=010126012879&query=ethical+funds, Internet, last accessed at 16/4/2001.

countries especially Europe, Australia and Canada, are increasingly getting involved in applying ethical or social screens. [8]

Islamic Equity funds can be pictured as another form of ethical investing, especially when it comes to the type of businesses these funds exclude. The foundation of IEFs screens is supposed to be derived from the basic tenets of Islamic law. Hence, these screens exclude all firms that violate the tenets of Islamic contract law. For this purpose, IEFs employ both qualitative and quantitative parameters. These parameters ensure that Muslims do not invest in impermissible types of businesses such as alcohol production, gambling, pornography, etc. Investing in interest (*riba*) based financial institutions is also not allowed. [9] In addition, the fund manager of an Islamic Equity fund is strictly banned from employing a number of advanced conventional techniques e.g. derivatives and margin trading.[10]

The screens of ethical and social based funds usually differ from one fund to another, it all depends on the values the fund attempts to promote. These screens are more value driven, and, hence the "ethical" label can apply to various, even contradictory screening strategies. For example, Meyers Pride Value (MYPVX) screens out firms that are "inhospitable" to their gay and lesbian employees, while

8 Canham, Jacqui, Screening for Green Investment, Financial Times On ILne Edition, available at: http://globalarchive.ft.com/globalarchive/articles.html?id=010126012879&query=ethical+funds, Internet, last accessed at 16/4/2001.

9 ihilal.com Educational web site, available at https://www.ihilal.com/wealth/islamicinvest.asp, Internet, last accessed at 16/4/2001.

10 Dow Jones University (2000), Principles of Islamic Investing, Dow Jones & Co. University, available at: http://ws1.dju.com, Internet, last accessed at 8/2/2000.

11 Hall, Emily, How to Pick a Socially Responsible Fund, available at: http://news.morningstar.com/news/MS/Article/0,1299,3180,00.html, Internet, last accessed at 16/4/2001.

the Christian-oriented Timothy Fund (TPLNX) avoids firms that provide domestic-partner benefits.[11]

The screens of IEFs are supposed to be derived from the same sources i.e. the different sources of Islamic contract law. This might be providing as competitive edge for the IEFs industry, in the sense that Muslims, through such funds, are able to invest collectively in specific countries, sectors and even in the same businesses, and these ultimately leverage their influence.

Most ethically based funds and all Islamic equity funds exclude firms that are involved in the gambling industry, this industry consists of three main categories: pari-mutuel betting at race tracks, state lotteries, and casino gambling.[12] Casinos are the biggest moneymakers and the driving force in the gambling industry. Casinos consist of large tables and machinery e.g. roulette wheels and slot machines. The reason behind the exclusion of the latter games does not much differ in these two types of funds. In the case of ethically based funds, most of the inspiration behind the exclusion stands for the negative impact of gambling on society, especially compulsive gambling. The roots of exclusion in the case of Islamic equity funds are purely based on Islamic contract law, furthermore, such exclusion is, to a certain extent, based on ethical matters.

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12 One Source Information Services, Inc., Industry Reports, available at: www.onesource.com, Internet, last accessed at 20/04/2001. [Subscription].

The ground of the screening criteria of IEFs is the different sources of Islamic contract law, and once any these sources prohibit Muslims from performing a specific act, Muslims with no doubt, are obliged to obey. However, in the case of ethically based funds, the issue is more dependent on investor's personal values, and most important these values might differ from one person or group to another. For instance, some argue that gambling, in a legalized form, has a positive impact on the society, the argument is based on that casinos create jobs since they are a labor intensive-type of businesses, and, hence, most of the employees appointed in casinos are those at the lower end of the economic spectrum who have most trouble getting jobs. In addition, legalized gambling is a highly taxed type of business that brings in new tax revenue to governments. In Islam - even supposing that casinos leave positive impact on the economy, Muslims are banned from being involved in such type of businesses.

5.3 Basics of Screening Criteria of Islamic Equity Funds

As mentioned previously, the existing screens of IEFs exclude firms that are involved in particular businesses and those firms that are highly involved with interest based transactions. Starting with the excluded businesses, the main businesses that pertain to this category include alcohol, gambling and financial services. Each of the different sources of Islamic contract law refers to these businesses and usually in a direct manner. For instance, the different sources of Islamic contract law strictly confirm that Muslims involved in alcohol are pursuing one of the major Sins and they will be accounted for it on the Day of Judgment. The involvement in alcohol undergoes different forms i.e. drinking it, distributing it, transporting it, presenting it as a gift, serving it, selling it and producing it for own consumption or for trading purposes. The following two verses are God's words on alcohol:

> They question thee about strong drink and games of chance. Say:
> In both is great sin, and (some) utility for men; but the sin of them is greater than their usefulness. And they ask thee what they ought to spend. Say: that which is superfluous. Thus Allah maketh plain to you (His) revelations, that haply ye may reflect.[13]

In an other verse God mentions the following:

> O ye who believe! Strong drink and games of chance and idols and divining arrows are only an infamy of Satan's handiwork. Leave it aside in order that ye may succeed.[14]

In addition, the Prophet Mohammed in many occasions has banned Muslims from dealing with alcohol. The following are two *hadiths* related to alcohol.

Narrated Jabir bin 'Abdullah:

13 The Quran: al-Baqarah [219.6].

14 The Quran: al-Madinah [5:90.6].

> ... Allah and His Apostle have made the selling of wine (i.e. alcoholic drinks) unlawful. [15]

Narrated Anas:

> I was the butler of the people in the house of Abu Talha, and in those days drinks were prepared from dates. Allah's Apostle ordered somebody to announce that alcoholic drinks had been prohibited. Abu Talha ordered me to go out and spill the wine. I went out and spilled it, and it flowed in the streets of Medina. Some people said, "Some people were killed and wine was still in their stomachs." On that the Divine revelation came:-- "On those who believe And do good deeds There is no blame For what they ate (in the past).[16]

The other business that all the screens of IEFs refer pertains to "gambling". The history of gambling prohibition in the Quran is very similar to the case of wine prohibition. Both of these acts were prohibited in the Quran simultaneously in al-Baqarah [2:219] and al-Ma'idah [5:91].

As for the case of *riba*, the screens of IEFs deal with this issue in two ways. The first is excluding all financial and insurance firms and any other related businesses in which their operations are based on interest to a large extent. The second way is focused on excluding any firm that deals with interest-rate based transactions in a significant manner (on relative basis). It is also worth noting that the screening criteria of IEFs exclude firms that significantly pays or receives interest. In other words, any firm that significantly borrows or deposits cash associated with interest is excluded. For this purpose, the *Shariaa* Supervisory Boards (SSB) of most IEFs and indexes agreed on setting some sort of quantitative analysis. This is despite the huge debate among Muslim scholars especially those conservative ones, on the way SSB dealt with firms involved in *riba*. These

15 Sahih Bukhari, Volume 5, Book 59, Number 590.

16 Sahih Bukhari, Volume 3, Book 43, Number 644.

conservative scholars argue that employing quantitative analysis is futile, because *riba* (usury) in any means and forms is *haram* in Islam, and they question why to employ quantitative analysis of firms that already deal with *riba* even if their involvement with *riba* is minor.[17] These conservative scholars base their argument on the following verse from the Quran.

> Those who swallow usury cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is just like usury; whereas Allah permitteth trading and forbiddeth usury. He unto whom an admonition from his Lord cometh, and (he) refraineth (in obedience thereto), he shall keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who returneth (to usury) - Such are rightful owners of the Fire. They will abide therein.[18]

In another verse God mentions the following:

> O ye who believe! Devour not usury, doubling and quadrupling (the sum lent). Observe your duty to Allah, that ye may be successful.[19]

On the other hand, a number of contemporary Muslim scholars permit Muslim investors to invest in firms that deal with *riba*, however with restrictions. Al-Bugami asserts that there are a number of Muslim scholars that support the opinion that permitting investing in stocks of firms that have a permissible main business activity but "marginally" deal with interest. These scholars include: - Sheikh Abdullah Ibn Sulaiman Manee's, Sheikh Mustafa Ahmed Al-Zarqa'a and Dr Ali Muhiyi Ad-Deen Al-Garah Daghi. According to the same source, these scholars justify their legal opinions on a number of assumptions. First, they argue that there are firms that have permissible operations, but deal marginally with interest, and the percentage of interest is very limited when compared with the

17 It can be argued that these scholars obviously advocate that firms get their required liquidity by equity offering rather than interest based financing.
18 The Quran: al-Baqarah [2:275.4].
19 The Quran: al-Imran [3:130.7].

income generated from non-interest transactions. They note that the shareholders of the firm can always purify the interest based income by providing it to charity. Secondly, the existing global financial system is highly dominated by the tenets of Capitalism, and it is almost impossible for those firms to avoid interest based transactions. Thirdly, many Muslim scholars agree with what Ibn Taimiyah says: "if necessity arises, prohibited matters can be allowable." [20]

Sheikh Bader Al-Matawalli Abdel who is a member of the Shariaa Supervisory Committee of Kuwait Finance House, he argues the following:

> The partnership principle in the shares of the industrial, agriculture and commercial companies is legally acceptable, as it is subject to profit and loss, which is some sort of speculative trade-profit, supported by the public opinions, provided that these companies avoid usurious transactions receiving or giving interest. It is understood from your observation that these companies are dealing with usury borrowing and lending, and so, according to given information that is supportive action to Usury, which was forbidden by the legislator.[21]

In addition, the United *Shariaa* committee of Dallah Al Baraka[22], issued the following Islamic legal opinion on stock investing:

> It permissible to buy stock of companies that have permissible operations and that deals occasionally with interest rate (borrowing and depositing) under the following conditions: - the purpose of buying the stock is advising the companies to operate according to the Islamic law. The investor has to be convinced that he owns the capabilities to achieve the change process, the investor is obliged to take the necessary steps and efforts to pursue the change achieve the investor must liquid all the assets held with the fund once he figure's out that he can't change the company's policies, any income generated interest-rate must be purified and spend on charity.[23]

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20 Al-Bugami, Saleh (1994), Rule on Subscription in Companies which Deposit or Offer Loans in Return for Interest, Contemporary Jurisprudence Research Journal, 21st edition, Nagd Trading Prints- Saudi Arabia., p. 33.

21 Kuwait Finance House, Formal Islamic Legal opinions on economic issues (1971-1986), p. 463.

22 Dallah Albaraka Group (established in 1969). The Unified Board passes Islamic legal rulings for the various institutions and is involved in organizing the annual Fiqh symposium which draws scholars from all over the world, as well as in the various Islamic banking and Shariaa educational publications and software.

23 Dallah AlBaraka Group, Fatawee Wa Twasiat Al-halakat Al –Fqhiahis Leqadia Al-Masrafia Al Muasara (1992-1996), page 148.

Usmani[24] asserts that investing in stocks is permissible in Islam under certain conditions. First, it is not permissible to invest in firms that provide impermissible services or commodities, these include the entire conventional financial service sector and other firms that are involved in the business of pork, Alcohol, gambling ... etc. Secondly, assuming that the main business of the firm is permissible, however it deals with interest based financing transactions, in this case, the shareholder is obliged to demonstrate his objection during the firm's annual general meeting. Thirdly, if the firm's total income is generated from any interest related transactions, the proportion of such income must be deducted from the dividend paid to the shareholder. Fourth, it is permissible to invest only in firms that own "non-liquid" assets, in order to avoid being trapped in *riba* dilemma, Usmani assures that money cannot be traded in except at its par value. In addition to the latter conditions, Usmani suggests that profits can be generated in two ways: - by dividends distributed or by the appreciation of the stock market value. In the former way a certain proportion of the dividend might include interest earned by the firm, in this case Muslim investors must purify this portion by giving it to charity.[25]

24 Taqi Usamani is one of the contemporary Muslim scholars that acts as a reference in many issues related to Islamic finance and banking, in addition he serves as a consultant for several international Islamic financial institutions and currently is the deputy chairman of the Jeddah based Islamic *Fiqh* Council of the Organization of Islamic Conference (OIC).

25 Islamiq.com Educational web site, available at: http://www.islamiq.com/knowledgecenter/shariah-funds.php4, Internet, last accessed at 16/4/2001.

5.4 General Stock Screening Strategies

Brill et al. mention that the screening criteria of "value" based mutual funds can be divided into the following four forms: - preventing screening, supporting screening, community investing screening, and shareholder activism screening. [26]

The idea behind the preventing screening is simple, all firms with businesses contradicting the main objective and philosophy of the fund are excluded (screened out). In other words, a firm with a negative behavior is excluded, and for this reason preventing screening is sometimes called "negative screening". Moreover, a specific type of business might be regarded as a negative behavior for a particular fund, at the same time might not be a negative behavior in a different type of fund, again it depends on the on the philosophy and the area of concern of the fund. For example, in the case of Islamic Equity Funds, banks and insurance firms are considered a negative behavior due to *riba*. On the other hand, mutual funds with environmental concerns do not consider the banks and other related businesses a negative behavior, in contrary, such businesses might be attractive because they do not produce any outputs which pollute the environment. Hence, firms that only pollute the environment are those with negative behavior.

The most common negative behavior among social, ethical and environmental mutual funds is the production of defense equipment and weapons. According to a study prepared by "The Social Investment Forum", among all mutual funds that are members in

26 See Brill, Hall, Brill Jack, and Feigenbaun Cliff (1999), Investing With Your Values, Bloomberg Press, USA.

the Forum (64 funds), about 85% of them exclude firms involved in the production of weapons and defense equipment.[27]

To date, most (if not all) Islamic Equity Funds (with no exception) employ preventing (negative) screening strategy, and this can be observed by referring back to the mentioned objective available in the prospectus. For instance, in the case of "Al-Ahli Global Trading Equity" fund - which is one of the most heavily subscribed Islamic Equity Funds, the main objective is: "to invest in shares of global companies whose principle activities are in compliance with Shariaa".[28] Even though the objective of the latter fund does not state directly that it excludes firms with negative behaviors, but it can be understood that any firm that does not "comply" with the *shariaa* rules will be excluded.

It is worth mentioning that the *shariaa* terminology in Islam is very central, and hence claiming that avoiding investing in firms with negative behavior does not necessarily mean applying the *shariaa* rules. Chapra asserts that: "In a Muslim society, the *shariaa* serves as the basis for them. These rules of behavior in general require people to fulfill their obligations toward each other and abstain from harming others." [29] Perhaps the screening criteria of Islamic Equity Funds is supposed to be more comprehensive so as to exclude firms that pollute the environment or those firms that treat their employees in a negative manner, rather than focusing on limited issues. That is, since *shariaa*

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27 Social Investment Educational web site, available at: http://www.socialinvest.org/areas/sriguide/mfsc.htm,Internet, last accessed at 30/03/2001.

28 Third Quarter Failaka Annual Report (2000), Published by Failaka International, Inc. USA.

29 Chapra, Umer (2000), Islamic and Economic Development, Alternative Visions of International Monetary Reform, Proceeding of the Second Harvard University Forum on Islamic Finance, Octobor 9-10, 1998, Harvard University, Massachusetts-USA , p.26.

emphasizes ethical, moral, social and religious factors, so as to promote equality and fairness for the good of society as a whole. [30] In this context, a number of questions emerge. Is it enough that the screening criteria of Islamic Equity Funds are limited to excluding firms with negative behavior? Is there a need to employ other different strategies? It can be argued that excluding a particular firm based on its negative behavior will not make it mend its ways. Hence, there will be always other market participants willing to buy the same excluded firm, noting that it is the cumulative effect that is important. From this stage the importance of other screening strategies emerge.

The second screening strategy is called affirmative screening or “positive screening”. As mentioned in the beginning of this chapter, that historically social and ethical funds avoided investing in the so-called "sin stocks" such as alcohol and tobacco manufacturers. Today, however, most of these funds are employing a different strategy, instead of excluding firms with negative behavior, these funds are looking for firms that boast strong environmental and social performance records. [31] In other words, these funds seek investment opportunities in firms that positively contribute to the world’s future economy. These funds desire firms that specialize in the production of alternative (no pollution) forms of energy, or natural food producers, etc.

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30 Dhumale, Rahul, and Sapcanin Amela (__), An Application of Islamic Banking Principles to Micro-finance, A study by the Regional Bureau for Arab States, United Nations Development Program, in cooperation with the Middle East and North Africa Region, World Bank.

31 Kroll, Karen (2001), Good Deeds Deliver, Industry Week, Jan 15, Cleveland.

It is argued that positive screening is relatively more complicated than negative screening in the sense that the latter is generally more straightforward. Once specifying the guidelines in the case of negative screening, it becomes easy to differentiate between firms that contradict these guidelines and those that do not, and the result is either black or white. However, the process of positive screening is involved with more complexity. It requires extensive analysis of different complex issues such as pollution, workplace practices, diversity, and product safety. [32]

One of major challenges facing IEFs is that these funds employ only negative screening strategy, although positive screening (as a proactive approach) might go along more with the Islamic *shariaa* teachings. Hence, rather than merely excluding firms with negative behavior, the investor methodically backs firms that exclusively operate according to Islamic teachings. Aware that employing this strategy must not be on the account of negative screening strategy, both strategies must go along together. For instance, assuming that there are two software firms that already passed the negative screening strategy. These both firms share a similar financial strength, nevertheless one of them is well known for providing charity for the third world region, and the other does not. Since the acts of the latter firm are in line with the basic tenets of Islamic law, according to positive screening strategy, the fund manger is suppose to give priority to the latter firm and this can be considered as one way of rewarding firms that support disadvantaged population of the Muslim world.

32 Social Funds Educational web site, available at: http://socialfunds.com/page.cgi/article2.html#a1, Internet, last accessed 30/03/2001.

The remaining two strategies are community investing screening and shareholder activism screening. These two strategies are regarded as more active especially when compared to the negative screening strategy. The community investing strategy is tailored for those investors that are willing to re-shape the community in order to become a better place to live. In regard to funds that employ this strategy, the fund manager usually invests in firms and organizations that benefit the community e.g. non-interest community banks, community hospitals, educational organizations such as universities and schools. This type of screening is unlike most other screening strategies in the sense that the latter strategies keep the investor at some distance from the community development institutions. [33]

In most cases, investing in community development institutions generates lower returns at a less degree of risk in particular when compared with investing in the other "hot" sectors in the economy. Investors who give credence to this strategy, know in advance that they will be receiving a more modest return, however, this in exchange for being able to leave an impact on the lives of people that live in economically disadvantaged communities. Moreover, investors are not obliged to direct a large portion of their individual portfolios to realize this impact. Diverting one percent of an investor's total portfolio leaves a minimal impact on the individual investor's total returns, and the collective impact of a new influx of community investment dollars would make an

33 See Brill, Hall, Brill, Jack and Feigenbaun Cliff (1999), Investing with Your Values, Bloomberg Press, USA.

effectual difference for those in disadvantaged communities.[34] In regard to Islamic Equity Funds, so far none of these funds employ a community investing screening strategy despite that such strategy might partially help out some of the disadvantaged Muslim communities.

The fourth and last strategy is called "shareholder activism screening". This strategy is suitable for those investors that have a desire to participate in changing the behavior of particular firms from a negative to a positive manner. In this context, shareholder activists usually employ several tactics in order to get their demands delivered. The first one is voting proxies in support of shareholders resolutions. If the tactic did not achieve it means, shareholders go further and start undertaking discussions with the firm's senior management. In cases where the management refuses to discuss their demands, shareholders have the option of supporting resolutions such as passing selective purchasing laws and promoting consumer boycotts. The last resort for shareholder activists is "divestment" i.e. selling the stocks of the offending firm, noting that this stage comes after several attempts by the shareholders to pursue issues with the management of the firm. Although divestment as a tactic may not be an affective weapon, especially in the case of small individual shareholder, it might be very influential in the case of institutional investors, pension funds and mutual funds. [35]

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34 Social Investment Forum (2000), Increasing investment in communities: a community investment guide for professionals and institutions, SIF Industry Research Program, September 15, available at; http://www.socialinvest.org/areas/research/communityinvest/CommunityInvestmentGuide.PDF, Internet, last at accessed 30/03/ 2001.

35 Social Investment Forum (2000), Increasing Investment in Communities: a Community Investment Guide for Professionals and Institutions, SIF Industry Research Program, September 15, available at; http://www.socialinvest.org/areas/research/communityinvest/CommunityInvestmentGuide.PDF, Internet, last at accessed 30/03/ 2001.

In the author's view, the fund managers and promoters of IEFs should start employing more advanced strategies other than negative screening. They should learn from the experience of social and ethical mutual funds. It might be right that employing a negative screening strategy will assure that Muslim investors are only investing in permissible stocks. However, this strategy is not efficient when it comes to changing the firms' negative behavior to a more positive one. In addition, implementing the negative screening strategy does not avoid Muslim investors from investing in firms that pollute the environment, or sell destructive weapons, etc. Last but not the least, the currently employed screening criteria does not able Muslim investors to demonstrate their support to firms that seriously attempt to base their operations on the basic tenets of Islamic law.

5.5 Survey of Screening Criteria of Islamic Equity Funds and Indexes

The purpose of this part is to explore the major screening criteria of Islamic Equity Funds and Indexes. These screens can be divided into two categories: - the first includes the major Islamic Equity Indexes such as: IslamiQ.com, Islamic Dow Jones Market Index (DJIM), FTSE Global Islamic Index Series, and Kuala Lumpur Stock Exchange *Syariah* Index (KLSE SI). The second category consist of the screens applied by the major financial management firms, these firms are in the business of managing IEFs e.g. Wellington Management Co., Wright Global, Citibank and Global Alliance.

(1) Screening criteria of Islamic Equity Indexes

- **Screening criteria set up by IslamiQ.com[36]**

The screening criteria of IslamiQ.com is based on qualitative and quantitative parameters, the members of the appointed *Shariaa* Supervisory Board (SSB) have approved these parameters. The screening process consists of four stages, and each stage consists of two steps. The first stage (a), involves an assessment of the sources of the firm's revenues and profits. Firms that are involved in "impermissible" businesses such as alcoholic beverages, casino and pork production are excluded. The first stage (b), involves an assessment of the firm's non-*halal* income, which may be derived from "ancillary" activities, as well as the firm's interest income. To serve this purpose, the "total interest income" divided by the firm's "gross total revenues" must be below 5%. The second stage (a) confirms that the firm's "debt to total assets" ratio must not exceed 30%. As for

36 IslamiQ.com is first Islamic financial portal on the net. The portal offers Muslims financial information and a variety of Islamic investing products. Just recently, via IslamiQ.com, Muslims are able to trade with Islamic "permissible" (halal) stocks and funds, as claimed by the IslamiQ.com.

the second stage (b), the "liquid assets" of the firm must not exceed 45% of the "total assets" as "per book" value. Firms that pass all the latter four stages are labeled as " permissible" firms.[37]

- Screening criteria set up by Dow Jones & Company

Dow Jones & Company is regarded as the first company to establish a number of professionals dedicated to Muslim investors. The main index is the Dow Jones Islamic Market (DJIM) launched on 1998. A number of sub indexes are derived from the main index such as Dow Jones Islamic US (DJIM-US) and Dow Jones Islamic Global Technology (DJIM-Global Technology). All eligible stocks are screened through a two stage screening process; the first step is selecting appropriate stocks out of the Dow Jones Global Indexes family (DJGI). The DJGI selection process removes stocks that are not suitable for global investing. Afterwards, a number of "Islamic investment guidelines" are applied to separate unlawful stocks from lawful ones. These investment guidelines consist of three filters. The purpose of the first filter is excluding firms with impermissible "primary" business activities i.e. alcohol, pork related products, conventional financial services (banking, insurance, etc.). Secondly, three financial-ratio measures are performed to ensure that firms are not "heavily" involved in interest dealings. The ratios include (total debt / total assets) which must be less than 33%, (accounts receivables / total assets) must be less than 45%, and the last ratio is the (cash

37 Islamiq.com Knowledge Center, available at: http://www.islamiqstocks.com/php/index.php3, Internet, last accessed at 20/04/2001.

and interest bearing securities divided by trailing 12- month average market capitalization) which must be less than 33%.[38]

- **Screening criteria set up by Financial Times Stock Indices**

The second major index is the FTSE Global Islamic Index Series (GIIS), which is derived from the Financial Times Stock Indices International (FTSE International). Similar to the Dow Jones Islamic Market Index, the FTSE Global Islamic Index Series (GIIS) is also serving as an equity benchmark tailored for those who wish to invest according to Islamic investment guidelines (as claimed by FTSE). The sub components of the FTSE Global Islamic Index Series (GIIS) are FTSE Americas Islamic Index, FTSE Europe Islamic Index, FTSE Pacific Basin Islamic Index, and FTSE South Africa Islamic Index. The screening criteria of these indexes is similar to the one established by Dow Jones, however in certain instances the criteria of the former index is less strict than the DJIM. For example, in order to indicate the extent that a firm is involved in interest based transactions, the GIIS only employ one financial ratio (interest-bearing debt divided by assets < 33%). However, in the case of DJIM, three financial ratios are employed for the same purpose.[39]

38 Dow Jones Islamic Market Index Guide, Dow Jones & Company, available at: http://indexes.dowjones.com/djimi/guide.pdf, Internet, last accessed at 20/04/2001.

39 Obaidullah, Mohammed (2000), Regulation of Stock Market in an Islamic Economy, Fourth International Conference on Islamic Economics and Banking, Loughborough University, August 13-15-2000. pp. 249-272.

- **Screening criteria set up by Kuala Lumpur Stock Exchange**

This index is called Kuala Lumpur Stock Exchange *Syariah* Index (KLSE SI) [40]. First, the screening criteria of (KLSE SI) excludes firms that are involved with impermissible activities, noting that the index explicitly excludes those firms that are involved with *gharar* (uncertainty) i.e. conventional insurance operations. The screen of (KLSE SI) proposes three qualitative guidelines and hence does not apply any financial ratios. The purpose of the first guideline is assuring that the core activities of the firm are not against the Islamic *Shariaa* law. Furthermore the impermissible (*haram*) must be "very small" compared to the core activities. Secondly, the "public perception" or the "image" of the firm must be "good". Finally, the core activities of the firm are "important" and "beneficial" (*Maslaha)* to the "Muslim *Ummah*" and the "country".[41]

Obaidullah (2000) [42] describes the screening criteria of KLSE SI as quite liberal, not objective and clearly judgmental in nature, which leads to the possibility of divergence of opinion. The most distinctive matter of the KLSE SI screen is the issue of *gharar.* As indicated in the criteria of the index, the reason for excluding insurance firms is due to *gharar*, which is defined as "uncertainty" according to the index. Other indexes exclude insurance companies due to *riba* and not *gharar*. In addition, contradictory to all other indexes, the KLSE SI screen does not mention (at least explicitly) *riba.* One can argue the reason is due to the fact that most publicly traded firms in Malaysia are highly leveraged

40 139 Obaidullah, Mohammed (2000), Regulation of Stock Market in an Islamic Economy, Fourth International Conference on Islamic Economics and Banking, Loughborough University, August 13-15-2000. pp. 249-272.

41 Ibid.

42 Ibid.

with interest based loans, and if a number of financial ratios are suggested, the investor will be unable to invest in the majority of firms due to *riba*. Also, it is worth noting that the screening criteria explicitly mentions that in order for a firm to be included in the index it must have a core activity that is "beneficial" *(Maslaha)* to the Muslim *Ummah*. This guideline is very general in its nature and can have various interpretations.

(2) Screening criteria of the major Islamic Equity Funds

After exploring the screening criteria of Islamic Equity Indexes, it is useful to explore the selection parameters and screening criteria of the major financial institutions involved in the business of Islamic fund management.

Table (5.1) compares the screening criteria of a number of world class global financial management firms. These financial firms include: Wellington Management Co., Citibank, Wright Global, and Global Alliance. It worth noting that these firms (specially Wellington Management Co. and Citibank) share a significant share of the total managed Islamic Equity Funds.

Table (5.1)[43]
Sample of Screening Criteria of Islamic Equity Funds

	Wellington Management Co.	Citibank	Wright Global	Global Alliance
(A)Non-permissible Industries Screens	Yes	Yes	Yes	Yes
(B) Financial Ratios				
Debt Trailing 12 Month Marketcap	N/A	N/A	N/A	N/A
Debt/Asset	N/A	<33%	N/A	N/A
Debt/Equity	<30%	N/A	<30%	<33%
Loan + Cash/Assets	N/A	N/A	N/A	<50%
Accounts Receivables/Assets	N/A	<50%	N/A	N/A
Account Receivables/Market Value	<50%	N/A	N/A	N/A
(Cash + Interest-Bearing Securities)/ Trailing 12 Month Marketcap	N/A	N/A	N/A	N/A
Interest Income/Total Revenue	<15%	N/A	<15%	N/A
3-year Average Interest Income/Total Income	N/A	N/A	N/A	<10%

The following points can be concluded from table (5.1). First, it is worth noting that none of the screens is exactly the same, despite the fact that financial firms promoting Islamic funds claim that the basis of screens they employ is Islamic contract law. Second, it is clear that the figures such as 33% or 50% are clearly arbitrary, the clearest evidence is that most of the screens have different figures, and, hence, none of the screens provide a justification of the raison d'être of choosing such specific figures or values. Third, the only constant parameter among all the latter screens is the "Non-permissible Industries Screen", and on that account all of the five institutions exclude non-permissible industries or businesses. The danger is that the majority of financial firms do not specify the

43, Dow Jones Islamic Market Index Guide, Dow Jones & Company, available at: http://indexes.dowjones.com/djimi/imparameters.html, Internet, last at 20/04/2001.http://indexes.dowjones.com/djimi/imparameters.html.

excluded industries and sub industries. And it can be argued that using the phrase "Non-permissible industries screens" or confining the excluded industries to very general type of businesses or sectors such as "alcohol" is to some point vague and deceptive. In this context, it is worth referring back to how Western countries classify different types of businesses and sectors. For instance, in the USA, each type of business is classified under a specific industrial code, and these codes are standardized under "Standard Industrial Classifications" SIC. In case of "alcohol", the industry is named "Alcoholic Beverages related industries" which is divided into three divisions:

- Division D: Manufacturing
- Division F: Wholesale Trade
- Division G: Retail Trade

Under these three divisions there are certain sub divisions, in which each of them is clearly specified. For instance, one the of the sub categories of Division F: Wholesale Trade is 5813 Drinking Places (alcoholic beverages). The latter subcategory is defined as:

Establishments primarily engaged in the retail sale of alcoholic drinks, such as beer, ale, wine, and liquor, for consumption on the premises. The sale of food frequently accounts for a substantial portion of the receipts of these establishments.

Drinking Places (alcoholic beverages) is then divided into the following:

- Bars (alcoholic beverage drinking places)
- Beer gardens (drinking places)
- Beer parlors (tap rooms)
- Beer taverns
- Beer, wine, and liquors: sale for on-premise consumption
- Bottle clubs (drinking places)
- Cabarets
- Cocktail lounges
- Discotheques, alcoholic beverage
- Drinking places, alcoholic beverages
- Night clubs
- Saloons (drinking places)
- Tap rooms (drinking places)

* Taverns (drinking places) Wine bars

From an Islamic point of view all of these latter alcohol related activities are banned. However, it is not clear if any of the screening criteria of IEFs and Indexes exclude them. The most comprehensive screening criteria (on a relative basis) is "Islamiqstocks.com". Its screening criteria indicates the following:

> Typical Non-Permissible Business Activities:
> • Alcoholic Beverages
> This includes the production, packaging, bottling, marketing, selling and/ or distribution of liquor and related products. Production facilities like breweries are automatically excluded.[44]

The screens of DJIM and FTSE indexes are not precise enough. For instance, the screen of Dow Jones Islamic Market Index indicates that:

> Stocks of companies whose primary business is in areas not suitable for Islamic investment purposes are excluded from the Dow Jones Islamic Market Index. Excluded products include: * Alcohol. [45]

The screening criteria of the FTSE Global Islamic Index Series deals with "alcohol" is as follows:

> By way of guidance, stocks whose core activities are or are related to the following are excluded: a) banking or any other interest related activity b) alcohol. [46]

It can be observed that none of the of the screens mentioned in table (5.1) are comprehensive enough to indicate, in a particular sense, which type of businesses are prohibited due to the selling of alcoholic beverages. In other words, it is still not clear

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44 Islamiq.com Knowledge Center, available at: http://www.islamiqstocks.com, Internet, last accessed at 28/04/2001.

45, Dow Jones Islamic Market Index Guide, Dow Jones & Company, available at: http://indexes.dowjones.com/djimi, Internet, last accessed at 28/04/2001.

46 FTSE Global Islamic Index Series, available at: http://www.ft-se.co.uk/, Internet, last accessed at 28/04/2001.

from the existing screening criteria of IEFs if Muslim investors are prohibited to invest in businesses such as supermarkets, hotel chains and airlines.

Another issue worth mentioning is that the previously discussed screens employ different ratios for the same purpose. For instance, in order to indicate the extent a particular firm is involved in interest-based transitions, the screen of Citibank uses a (debt/asset) ratio. On the other hand and for the same purpose, Wellington Management Co. uses (debt/equity). Noting that there is a huge difference between both terms "equity" and "asset". A good illustration is the case of Microsoft (MSFT). As observed from its year 2000 balance sheet[47] the firm's "total assets" equals $52,150.000, however, its "total equity" is equal to $41,368.0. Hence, the difference between the last two figures is more than 10.0 billion dollars. Therefore, it can be logically asserted that those screens that include (debt/asset) are stricter than the ones including the (debt/equity). Last but not the least, if a close look is taken at the screen of Global Alliance, it is observed the calculation of the (interest income / total income) is based on the 3-year average interest income, and this is not similar to the other screens which usually employ a 1-year period or the most recent financial result.

47 Money Central, available at: http://moneycentral.msn.com/investor/invsub/results/statemnt.asp?Symbol=msft, Internet, last accessed at 21/04/2001.

5.6 *Gharar* and the Screening Criteria of Islamic Equity Funds and Indexes

It is clear that most of the latter screens employ both qualitative and quantitative parameters. The purpose of qualitative parameters is excluding any industry or business that is not compliant with the Islamic contract law. The quantitative parameters employ several financial ratios, and that is to indicate the extent the firm is involved in interest based transactions. It is observed that from all of the latter screens, the only index or fund which excludes a certain industry or stock due to *gharar* is the Kuala Lumpur Stock Exchange *Syariah* Index (KLSE SI). However, the (KLSE SI) remark of *gharar* is applied to rationalize the exclusion of conventional insurance firms, despite that these firms are already excluded from all of the previously mentioned screens but under the category of "impermissible industries or businesses ".

In short, the screening criteria of Islamic Equity Funds and Indexes do not consider *gharar* a serious issue, despite *gharar* is prohibited according to the different sources of Islamic contract law. It also can be concluded that the focus of the latter screens is limited to *riba* and the type of businesses. It is interesting to explore the reasons behind not adding *gharar* to the screening criteria of IEFs. Is it because *gharar* has nothing to do with stock investing? The problem is that Muslim scholars are completely aware of the importance of *gharar,* but may be they are still unable to solve the dilemma of indicating and dealing with *gharar* in the case of stock investing. The other question is it possible to link *gharar* with speculation, high risk, gambling and uncertainty in the case of stock markets? For instance, a recent Islamic brokerage firm have warned its investors from being involved in speculative financial transactions specially short-term speculation, because that is prohibited in Islam. Moreover, this brokerage firm mentions that Muslims are obliged to explore the fundamental value of the firms in advance of buying the stock of this firm. [48]

The latter survey indicates that *gharar* is not evident in the screening criteria of IEFs. Note that there is very limited research that clarifies the reasons behind the exclusion of *gharar*, thus the researcher of this thesis suggests the following two reasons. First, there is a group of conservative Muslim scholars that do not agree on several aspects of the screening criteria of IEFs. For instance, these scholars criticise the values of the currently applied quantitative ratios, they argue that these values are selected arbitrary. Consequently, there is a huge debate of the extent to which the current screening criteria of IEFs is fully compatible with the different sources of Islamic contract law. Secondly, the whole idea of developing screening criteria of IEFs is relatively new, hence, ten years ago such a criteria was not evident. Accordingly, there is still much room for developing and adding some major aspects to the criteria of IEFs. In short, the current screening criteria of IEFs is still questionable from an Islamic perspective, and not including *gharar* does not necessarily mean that *gharar* is insignificant.

48 ihilal.com Educational web site of, available at: https://www.ihilal.com/wealth/invest3.asp, Internet, last accessed at 16/04/2001.

CHAPTER 6

STRATEGIES FOR MANAGING RISK RESULTING FROM *GHARAR*

6.1 Overview

The purpose of this chapter is to clarify the different conventional strategies of managing risk resulting from stock investing. The thesis divides these conventional strategies into four main ones, each one of them is analysed from an Islamic perspective, in order to decide on which of these strategies can be applied by Muslims for the purpose of *gharar* reduction.

6.2 Introduction

The negative and unpredicted events that occurred in financial markets during the last decade have lead to a clear conclusion; the sophistication of the risk management methods in place were clearly inadequate for the level and type of risks confronted. Kimball assures that:

> … despite the increased academic and professional attention paid to risk management, frequent instances still occur when sophisticated investors or firms experience sudden, unexpected, and devastating losses. [1]

Jorion admits that since 1970, the volatility in financial markets has increased. [2] The author supports his statement by citing a number of major incidents that occurred in different stock markets around the world, including:

- The oil price shocks, especially the one in 1973, resulting in high inflation and wild swings in interest rates.

- The Black Monday, October 19, 1987, in which the U.S. Stock market collapsed by 23 percent, wiping out $ 1 trillion in capital.

- The bond debacle of 1994, where the Federal Reserve Bank - after having kept interest rates low for 3 years - started a series of six consecutive interest rate hikes that erased $1.5 trillion of global capital.

- The deflation of the Japanese stock price bubble 1989; a total of $ 2.7 trillion in capital was lost.

- The 1997 Asian turmoil, in which three-fourths of the dollar capitalisation of equities in Indonesia, Korea, Malaysia, and Thailand was wiped off.[3]

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1 Kimball, Ralph (2000), Failures in Risk Management, New England Economic Review, Jan-Feb 2000, Boston-USA., p.4.

2 See Jorion, Philippe (1997), Value at Risk: the New Benchmark for Managing Financial Risk, Mc GrAw hill.

3 Ibid.

Jorion illustrates that the common characteristic shared among the previously mentioned events is "unpredictability". [4] Hence, "financial risk management" provides a partial protection against various risky events. The question is why did the latter events occur although sophisticated financial risk management tools existed at that time? Fernandez clarifies that a number of developments in securities markets - which occurred simultaneously - may have substantially contributed to the volatility in stocks. The developments include: the revolution that has occurred in information technology, a sweeping overhaul of the supervisory and regulatory environment in financial markets, the forces of globalisation; and, shifts in the demographic profile of the investor base. [5]

Volatility in many cases causes a negative impact on the "balance sheets" of market participants, particularly in the case of "margin accounts". Adding leverage magnifies the impact of price fluctuations on an investment stock account and increases the likelihood of a forced liquidation of stock holdings if a margin call can not be met. [6] It might be argued that Muslims are also influenced by events that cause volatility in stock markets. In fact, the results of increased volatility might affect Muslim investors more severely than other investors due to the prohibition of hedging techniques in Islam. For this purpose, there is a need for suggesting a number of different strategies that assist in dealing with the risk associated with stock investing. This ultimately leads to the reduction of *gharar*.

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4 See Jorion, Philippe (1997), Value at Risk: the New Benchmark for Managing Financial Risk, Mc Graw-Hill.

5 Fernandez, Frank and Chase Judith (2000), High Volatility: A Cautionary Tale, Vol. I, No. 4, available at http://www.sia.com/reference_materials/pdf/RsrchRprtVol1-4.pdf, Internet, last accessed at 04/03/2001.

6 Ibid.

6.3 General Strategies for Dealing with Risk

Emery & Finnerty suggest a number of risk-reducing tactics. These include:

1. Buying insurance against property and casualty liabilities claims
2. Using financial futures and contracts to hedge against fluctuations in foreign currency exchange rates, interest rates, and commodity prices
3. Avoiding risky markets and risky products
4. Using low levels of financial leverage even when there are substantial tax advantages to using higher debt financing levels.[7]

Not all of the latter tactics and methods are compliant with the different sources of Islamic contract law. Initially, Muslims are prohibited from employing the concept of commercial insurance. The common objection among Muslims to life insurance is on the grounds that it reflects doubt that God has "decreed" the moment of human being's death, or "distrust" in God's destiny. [8] In addition, *gharar* and *riba* are the other two objections Muslim scholars hold against commercial insurance. With regard to the second tactic, Muslims are prohibited from dealing with hedging and derivatives due to several reasons; one of them is *gharar*. This issue will be explained more extensively within the context of the coming subtitle i.e. "transferring-risk strategy". The third and fourth risk-reducing methods come closer to the basic tenets of Islamic law. As for the "avoidance of risky markets and risky products", this is the thrust of the thesis. One of the objectives of the thesis is suggesting a number of tactics and methods for *gharar*-reduction purposes, and hence, the foundation of these tactics is derived from the contemporary conventional valuation models. As for the fourth tactic, it is worth noting that the existing criteria of Islamic Equity Funds exclude firms that are heavily leveraged, and that is to deter Muslims from investing in firms that are engaged in *riba* dealings.

7 Emery, Douglas and Finnerty John (1997), Corporate Financial Management, Prentice-Hall, Inc. , p. 872.

8 Vogel, Frank, and Hayes, Samuel (1998), Islamic Law and Finance: Religion, Risk, and Return, Kluwer Law International, Boston-USA, pp.151-152.

In general, there are four common strategies for dealing with risk, these include: avoiding-risk, retaining-risk, transferring-risk and sharing-risk. The premise is to attempt utilising these strategies in order to achieve the ultimate objective of the thesis. In other words, these strategies are designed in a way to reduce risk. However, the thesis concern is more precise; reducing the avoidable risk resulting from significant and unnecessary uncertain outcomes, which is the suggested definition of *gharar*. Accordingly, an attempt is made to examine the compatibility of each conventional risk reducing strategy from an Islamic perspective.

6.3.1 Avoiding-risk Strategy

This strategy can be regarded as the most short cut method of dealing with risk. In this strategy, the market participant avoids investing in any stocks that are associated with risk, and this is obviously not practical in the real world since there must be some sort and degree of risk resulting from investing in a specific firm. For the purpose of avoiding of risk, market participants (other than Muslims) are able to invest in fixed-income securities. Such investment can serve, in a certain way, as an alternative to stock investing, although the income is relatively lower but almost guaranteed. So what are fixed-income securities? Are Muslims allowed to invest in this type of securities? If not, what are the reasons behind the prohibition of investing in these securities? What is the alternative for those Muslim investors who are not willing to risk their own money in stocks?

A fixed income security is one in which the issuer (borrower) has agreed to make income payments to the benefit of the security holder.[9] The security holder will receive a fixed and agreed amount of cash paid by the issuer for a specific period of time. It is also possible that the security issuer agrees to make a payment determined on the interest rate paid on six months (or other periods) deposits. In this case, the cash amount received by the security fluctuates every 6 months depending on the interest rate charged for the same period.

9 Fabozzi, Frank (1998), Investment Management, Prentice-Hall, Inc. , p. 438.

A Fixed-income security is divided into an equity obligation or debt. With regard to the equity obligation - usually pictured as preferred stocks - the security holders maintain a favoured arrangement specially when compared to common stock holders. The owners of preferred stocks are expected to receive a fixed-income payment. With a debt obligation; usually pictured as bonds, the issuer is obliged to pay a pre-determined percentage of par value on selected periods, and also to repay par or principle value of the bond at maturity. In return, the holder of the bond pays the issuer a given sum of cash on instant basis. [10]

There are Muslims that do not intend to invest in any type of stocks, and thus to avoid getting trapped in *haram* matters such as *riba*, and by this means, these Muslims ultimately avoid any type of risk resulting from stock investing. These investors abide by the opinion issued by a number of "conservative" Muslim scholars. These scholars argue that investing in stocks in any means is *haram.* Al-Bugami assures that there are a number of Muslim jurists that hold the opinion that investing in stocks is *haram.*[11] In this context, the author refers to the following verse from the Quran "O ye who believe! Fear God, and give up what remains of your demand for usury, if ye are indeed believers."[12] God in the latter verse clearly asks Muslims to give up all amount of usury.

It is clear that in today's world a significant percentage of firms are to a certain extent engaged in *riba*, this evolve either from borrowing cash from conventional banks or by depositing excess funds in the same sort of banks. Accordingly, some Muslims avoid

10 Levy, Haim (1999), Introduction to Investments, South-Western College Publishing, p. 30.

11 See Al-Bugami, Saleh (1994), Rule on Subscription in Companies which Deposit or Offer loans in Return for Interest, Contemporary Jurisprudence Research Journal, 21st Edition., Nagd Trading Prints, Saudi Arabia.

12 The Quran: al-Baqarah [2:278].

investing in such firms. The problem is that the available investment alternatives for those Muslims who reject investing in stocks are limited. In addition, investing in fixed income securities are also prohibited due to *riba.* Two scholars argue that:

> Debt securities, such as bonds, present problems if utilized by Islamic firms and made available to Muslim investors through the stock market. A traditional Western style corporate bond is likely to fail any test of acceptability. To begin with they are interest based, paying a fixed return attributable to the period of the debt. Penalties are imposed in the event of default, with bondholders typically entitled to take action against the issuer to recover the outstanding interest and principal. Such penalties are deemed to be unIslamic as they are close to usury, the principle reason for the prohibition of interest in Islam. [13]

In this context, the following question emerges, is there an available "permissible" alternative investment for Muslims that seek low risk? There is no doubt that the lawful investment alternatives are very limited. One of these alternatives, which is extensively offered by Islamic banks, is called "*Mudaraba Deposit Account*". This type of account is based on *mudaraba* mode; the Islamic bank invests the cash collected from the depositor against a predetermined fee. Also just very recently, Muslim scholars developed an Islamic acceptable bond called "*qirad* bond".[14] In this financial arrangement, the bondholders participate in the revenues of a particular project, and a portion of the revenue (after meeting direct expenses) would be paid out to the bondholders to pay back their initial investment. In most cases, the issuer will guarantee the return of the face value of the bonds at the end of the of the contract life. [15] Islamic banks in Malaysia, in addition to the Malaysian government, have been offering *qirad* bonds and other

13 Naughton, Shahnaz and Naughton, Dordrecht (2000), Religion, Ethics and Stock Trading: The Case of an Islamic Equities Market, Journal of Business Ethics, Jan, Vol. 23, Issue 2, p. 149 (145-159).

14 See: Decision 5 (D4/08/88), fourth session, Fiqh Academy Journal 3:2161.

15 Vogel, Frank, and Hayes, Samual (1998), Islamic Law and Finance: Religion, Risk, and Return, Kluwer Law International, Boston-USA, p169.

modified bonds. Note that Muslim scholars from the Middle East have not advocated such types of bonds.

Tirmidi focuses on the *hadith* "*Al-Kharaj bi-al-daman*"[16], which literally means, "gain accompanies liability for loss". According to this concept, any profits in Islam must be accompanied with risk. Accordingly, it is unacceptable for Muslims to earn any fixed or guaranteed income, there must be a degree of risk resulting from the possibility of loss. By referring back to the *qirad* bond, it can be concluded that any amount above the face value of the bond is not guaranteed, however, the initial investment or the face value is guaranteed. If the analysis of the permissibility is restricted to the "*Al-Kharaj bi-al-daman*" concept, it can be concluded that there is no problem in guaranteeing the initial investment amount noticing that *Al-Kharaj* literally means profits or gains. Therefore the risk is associated with the return or the gain resulting from the transaction, and nothing has been mentioned with regards to the initial amount of investment. The central issue for Muslims is to avoid being engaged in any financial transaction that is accompanied with a guaranteed fixed amount of income or profit.

Despite what has been said previously, there are a number of major Islamic finance modes that prohibit the idea of guaranteeing the initial invested amount. For instance, in the case of *mudaraba* and *musharaka*; which are both regarded as central modes in Islamic finance, the investor and agent manager are both obliged to share both profits and

16 Abu Dawud, Tirmidi , Al-Kharaj bi-al-daman, Nasa'I, Ibn Maja.

losses. Once the agent manger guarantees the initial invested amount the contract becomes invalid. And from this point, the question mark on *qirad* bonds emerges.

The practice and offering of *qirad* bonds by Islamic banks and Muslim governments is limited, and this is due to many reasons. First, not all Muslim scholars accept the concept behind this type of bond, especially when it comes to guaranteeing the bond's face value. Second, the stock markets in most Islamic countries are not advanced enough to offer such type of bonds. Third, most of the economies in Islamic countries are based on *riba*, and the central banks of these countries are used to issuing similar types of bonds that are offered in conventional economies i.e. fixed-income bonds.

It is observed from the latter arguments that the "avoiding risk strategy" is not a concrete alternative for Muslim investors, and this is mainly due to the prohibition of fixed income securities in Islam and the limited permissible investment alternatives. In addition, there is a lack of other professional permissible investment alternatives. Consequently, it is worth identifying and exploring other types of strategies in which the Muslim investor can employ for the purpose of minimizing risk, achieve profits, and most important, these two issues must be in the boundaries that are set by the different sources of Islamic contract law. This leads us to alternative strategies designed for risk reduction.

6.3.2 Retaining-risk Strategy

Risk retention strategy is regarded as one of the most common methods of dealing with risk.[17] According to this strategy, the market participant might retain risk by one of the following two ways: (1) retain risk with quantifying the exposed risk, and (2) retain risk without quantifying the exposed risk. The latter way of retaining risks is being influenced by of globalisation and deregulation of the financial sector. These days, market participants, especially speculators, are able to perform stock trading transactions by owning virtual (online) brokerage accounts. This development enables market participants to bypass the role of the certified brokers and other related third parties, and most importantly, the cost of these financial transactions is considerably low. Consequently, the market participant is able to trade stocks without assessing the risk associated with investing in a particular stock. The problem is that certain market participants lack the required skills and knowledge that enable them to assess the proper market value of a potential firm. Such less informed market participants simply follow market sentiment and pour money into "popular" stocks. These participants prefer to invest with the crowd because in so doing they feel they are less exposed to risk ("safety in numbers").

As for the other way of retaining risk i.e. retaining risk with quantifying the exposed risk, the market participant is able to pursue a number of steps in advance of the execution of the stock trade. These steps can be accomplished either by the market participant on his

17 See Vaughan, Emmett (1999), Fundamentals of Risk and Insurance, John Wiley & Sons, Inc.

own, or by outsourcing advice from a specialised individual or an investment firm. In the case of the former, two general methods can be employed. First, in order for the participant to asses the risk associated with investing in a particulate stock of firm, he is able to pursue certain tactics derived from different stock valuation models e.g. Modern Portfolio Theory, Value Investing approach and different types of derivatives. The second method, which is simpler than the prior one, requires the market participant to refer back to certain recommendations prepared by investment professionals and financial analysts. These professionals attempt to determine the certain characteristics of particular stocks and to ultimately identify mis-priced ones.[18]

Alternatively, the market participant has the option of passing the whole investment valuation process to a professional investment manager. Siegel is one of the scholars that recommend such an alternative. He asserts that:

> Proper investment strategy is as much of a psychological as an intellectual challenge. As with other challenges in life, it is often best seek professional help to structure and maintain a well-diversified portfolio. If you should decide to seek help, be sure to select a professional investment advisor who agrees with the basic principles of diversification and long-term investing...[19]

Investment advice and recommendations provided by investment managers get more effective in cases where market participants lack the required experience in stock investing valuation. These market participants are unable to estimate the current and future value of a potential firm. The problem associated with unskilled participants is that

18 See Alexander, Gordon, Sharpe, William and Bailey Jeffery (1993), Fundamentals of Investments, Prentice-Hall Inc, New Jersey-USA.

19 Siegel, Jeremy (1998), Stocks for the Long Term, McGraw-Hill, p..290.

the likelihood of being involved in transactions that contain significant uncertainty is high. Consequently, in order for Muslim market participants to reduce the possibility of being trapped in stocks associated with *gharar*, it is necessary to perform certain tactics and analysis derived from several valuation models. If the market participant is unable to do so, it is suggested to refer back to an investment specialist. Employing any of the latter options is considered as a way of seeking the current and projected "true" value of a particular firm, and even if the predicted value did not occur in the future, Muslim participants would be "Islamicaly" rewarded. Al-Suwailem points out:

> The proper seeking of the truth (*ijtihad*) is rewarded, even if the desired (uncertain) outcome is missed. Thus causes are valued in themselves as long as the outcome they determine is valuable.[20]

Investment professionals can be divided to "financial analysts" and "personal financial advisors". In regard to financial analysts, their main focus is on gathering and analysing information on a particular firm. These analysts also perform a variety of duties such as assessing and reporting on stock offerings, coming to terms of mergers and acquisitions, and evaluating the firms' financial strength. Based to their extensive analysis performed on particular firms, these analysts usually advice their clients one of the following three: buy, hold, or sell stocks. [21] As for personal financial advisors, their goal is helping market participants in the process of selecting the most appropriate investment options available

20 Al-Suwailem, Sami (2000), Towards an Objective Measures of Gharar in Exchange, Islamic Economic Studies, Oct. 99- Apr. 2000, Vol. 7, No. 1 & 2, p.140.

21 Dillon, Hall (2000), Financial Analysts and Personal Financial Advisors, Occupational Outlook Quarterly, Summer, Vol. 44, Issue 2, Washington-U.S.A., p. 27 (25-30).

in the market. This requires the financial advisor to be aware of both the financial status and goals of the customers.[22]

In general, the investors' and fund managers' style in managing a portfolio of stocks can be divided into "passive" investment management and "active" investment management. The style in both cases relies on two factors: (1) their opinions with regard to the way the stock market is priced and (2) their opinions about the sufficiency of their own personal knowledge. [23] Active investors rely on human judgement to determine the securities of the portfolio they hold, and that occurs on a on going basis. Such investors assume that the stock markets are never fully efficiently priced, therefore they can profit from buying "undervalued" stocks and selling "overvalued" ones. In some cases, the existence of these lucrative opportunities encourages these investors to pursue an aggressive investment style, in which they buy and sell stocks in order to maximise "trading" profits.[24] Active fund managers undertake two forms of managing their funds. The first form is called "traditional" management, which relies on the manger's ability to look at all relevant information, and consequently judge the stock's proper value. The second forms is named as "quantitative" management, which relies on employing human judgements for the cause of building particular valuation models, afterwards these models are applied in an objective manner. [25]

22 Dillon, Hall (2000), Financial Analysts and Personal Financial Advisors, Occupational Outlook Quarterly, Summer, Vol. 44, Issue 2, Washington-U.S.A., p. 26 (25-30).

23 Radcliffe, Robert (1994), Investments: Concepts, Analysis, Strategy, HarperCollins College Publishers, p. 476.

24 Francis, Jack (1991), Investment: Analysis and Management, 5th ed., McGraw-Hill, p.216.

25 Lederman, Jess and Klein, Robert (1994), Global Asset Allocation: Techniques for Optimising Portfolio Management, John Wiley & Sons, Inc., p..350.

With regard to passive investors, they assume that most investors in the stock market are highly informed and a certain degree of consensus exists regarding most securities' intrinsic values. These investors further believe that performing security analysis and trading aggressively is problematic and is associated with high degree of risks. [26] Passive investors prefer investing in particular type of funds such as "index funds". In this type of funds, the fund manager only purchases are limited to those stocks that are already included in particular indexes e.g. S&P 500. [27] It is worth indicating that passive investors perform the same duties and decisions that active investors perform except the process related to security analysis and selection. [28]

It is observed that in both cases active and passive investment management styles, the market participants are involved in risk-retaining strategy. In other words, the participants may not pursue any steps towards reducing the confronted risk. In regard to active investors, they might actively trade stocks without employing any of the stock valuation models, accordingly these investors are unable to assess the risk associated with investing in a particular stock in a proper manner. There are certain types of active investors that limit their focus to generating profits even if that might be associated with significant risk. And from this point, the participant's involvement with *gharar* flourishes.

As for passive investors - assuming that such participants only invest in index funds and likewise instruments - their involvement in stocks that might be associated with *gharar*

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26 Lederman, Jess and Klein, Robert (1994), Global Asset Allocation: Techniques for Optimising Portfolio Management, John Wiley & Sons, Inc., p..350.

27 Francis, Jack (1991), Investment: Analysis and Management, Fifth Edition, McGraw-Hill, p..218.

28 Radcliffe, Robert (1994), Investments: Concepts, Analysis, Strategy, HarperCollins College Publishers, p. 476.

is dependent on the type and objectives of the fund. For instance, there are funds that only select "high-growth" stocks from a certain index. This type of fund is usually categorised as "high risk funds". Due to the nature of stocks included in this fund, this type of fund might involve *gharar*. Note that Muslims are only permitted to invest in index funds that are compliant with the Islamic investment guidelines. Because these funds employ a screening criteria that filters out impermissible stocks, in other word, and firms; that are highly involved in *riba* and own an impermissible type of business(s), are excluded. The number of the Islamic equity funds that are based on Islamic equity indexes are very limited. Therefore, it is difficult for Muslim investors to invest in "Islamic compliant" index funds.

6.3.3 Transferring-risk Strategy

Transferring-risk strategy allows the stock market participant to transfer the exposed risk to another party that is more willing to bear risk. In the world of finance and investments, such strategy is named hedging; which is a way of reducing of risk associated with holding a particular type of security. Hedging in stocks implies when the participant guards against the risk resulted from price changes in a particular stock by buying or selling another stock whose price changes in an opposite direction. In many cases, hedging is very similar to the idea behind conventional insurance.

Although the thrust of the different types of hedging is essentially reducing specific types of risks, Muslims are strictly prohibited to deal with it. So why is hedging prohibited in Islam, noting that it might be used in a productive manner? Is it because one of the myths of hedging (specially derivatives) is a fancy name for gambling, and, hence, gambling is unlawful in Islam? Or is the prohibition based on that derivatives increase the volatility of stock markets? Why is the *salam* contract (similar to forward contracts) permissible from an Islamic perspective, but forwards are not? What is the alternative for those Muslims who aim to reduce risk by hedging? In order to be able to tackle these questions, it is essential first to explore the concepts of different types of hedging techniques and derivatives.

6.3.3.1 Basis of Hedging

There are various kinds of hedging techniques e.g. futures, forwards, options, swaps, etc. The value of these hedging techniques (derivatives) is determined by (or "derived" from) the price of an existing financial asset e.g. such as stocks, bonds or currencies. The focus in this chapter is limited to futures and options and to some extent forwards, and this in light of the importance and popularity of these financial contracts.

Originally, futures markets were developed for food and fibre crops, nevertheless, futures markets these days are more comprehensive. Future markets include: livestock, precious and industrial metals, different energy products, different type securities, inter-bank deposits, currencies and stock indexes, as well as other intangibles such as catastrophic insurance. [29] A futures contract is a standardised agreement between two parties that commits one to sell and the other to buy a stipulated quantity and grade of a specified item at a set price on or before a given date in the future.[30] Such contracts require the daily settlement of all gains and losses as long as the contract remains open, and for contracts remaining open until trading terminates, provides either for delivery or a final cash payment (cash settlement). The mechanism of futures involves that both buyers and sellers deposit funds (margin) with brokerage firms; these funds are described as "performance bond" or "good faith" deposits. The sum of the deposits is insignificant, usually not more than 10 percent of the total value of the item underlying the contract.[31]

29 Siegel, Jeremy (1998), Stocks for the Long Run, McGraw-Hill, p. 210.

30 Future Industry Institute, Introduction to the Futures and Options Markets, available at: http://www.fiafii.org/tutorial/contracts.htm, Internet, last accessed at 25/05/2001.

31 Ibid.

An Option is another type of derivatives. Such financial contract provides the right (not the obligation) to exchange a determined amount of a commodity, currency, index or financial instrument at an agreed price on or before a given future date. [32] Options are considered more basic instruments than futures. The latter can be replicated with options. The reverse, however, is not true. There are certain prerequisites for futures and options markets. The following are the major ones. First, the contract must provide the ability for participants exposed to price risk to potentially shift it to another market participant that is more willing to accept it. Second, the price of the underlying financial asset is required to change substantially, this is to guarantee the efficient in the shifting process of price risk. [33] Hence, wherever there is price volatility, there is a capacity for derivatives.

With regard to forward contracts, it can be defined as customised futures contracts. In this contract, the buyer and seller agree to buy or sell a financial asset at a predetermined future time and price. [34] This contract can be used for several purposes, for instance, the producer agrees to deliver a specific item to a merchant on a specified time and price.

The major difference between futures and options is based on the rights and obligations the market participants enjoy. In futures contracts, the buyers and sellers are obliged to perform the contract. And this can be done either by an offsetting transaction or by delivery. Loss and profits - in the case of futures - are equal to the difference between the price agreed on when the contract was initiated and when it was terminated. With regard

32 Future Industry Institute, Introduction to the Futures and Options Markets, available at: http://www.fiafii.org/tutorial/contracts.htm, Internet, last accessed at 25/05/2001.

33 Ibid.

34 Ibid.

to an option contract, the buyer of the option has no obligation to perform and complete the contract. The loss is limited to the premium already paid. In order for the buyer to earn profits, the price must increase to a higher level of the (call option), or decrease below the (put option). Sequential, the option seller (writer or grantor) is obliged to fulfil the option contract if the buyer so chooses, and that is in exchange for the premium received. [35]

Futures have a number of characteristics that distinct them from equities. For instance, the purpose of futures is to facilitate the risk shifting process. However, the central purpose of equities markets is the furtherance of capital creation. Another distinction is related to the difficulty of establishing short positions. In the case of futures trading, every long position must be accompanied with a short one, and as a result, short positions are very common. Short positions in the case of equities markets are minor, in addition, the ownership of equities requires borrowing the securities. Furthermore, the market participant in the case of futures contracts is required to deposit funds that are called good faith money. There is no interest charged to maintain a futures position. In contrast, the margin accounts resulting from security purchasing are considered as a down payment, and the balance of the margin account is interest charged.[36]

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35 Future Industry Institute, Introduction to the Futures and Options Markets, available at: http://www.fiafii.org/tutorial/contracts.htm, Internet, last accessed on the 25/05/2001.

36 Ibid.

6.3.3.2 Sequences of Hedging

After exploring the major definitions and concepts of derivatives, it is time to clarify the sequences resulting of the implementation of particular types of derivatives. Derivatives might be regarded as productive financial instrument, since it permits both producers and consumers to transfer risks in a way that both participants will end up better off. Derivatives may be utilised for the purpose of reducing uncertainty, and this enables firms to initiate productive activities that might not otherwise be pursued.[37] For example, a firm located in Jordan, may want to set up a factory in the United Kingdom, but it is concerned about the project's overall cost due to the exchange-rate volatility between the Jordanian Dinar and the Sterling pound. To ensure that the firm will have the required available funds to cover up the cost of the factory, the Jordanian manufacturer would pursue a precise risk-management plan that is in line with the firm's broader objective of building a factory in the U.K. In this case, financial derivatives are a workable alternative. The Jordanian firm is required to employ financial derivatives for the purpose of hedging against the differentiation of the sterling foreign-exchange rate against the Dinar, and this ultimately will improve the management of cash flows at the firm level. It is central that the firm has a sense of the direction of the dollar, and this requires timing the market in a professional manner.

Futures markets are regarded as the most liquid of all global financial markets, in addition, these markets provide low transaction costs and ease of entry and exit.[38] It is

37 Siems, Thomas, Policy Analysis: 10 Myths About Financial Derivative, available at: http://www.cato.org/pubs/pas/pa-283.html, Internet, last accessed at 25/05/2001.

38 Ibid.

worth indicating that firms functioning on a global basis are required to have a clear risk-management formula as part of its overall strategy. Hedging can be employed to ensure that the firm has the necessary funds at its disposal, and this helps the firm in the sense of pursuing its planned investments. By the latter means, financial derivatives help firms in reducing uncertainties and promote more productive activities.[39] It is argued that firms that do employ financial derivatives in their overall strategy for the purpose of hedging risk are in a more stable financial position from those firms that do not employ them. According to the Steven Wallman Commission:

> The commission recognizes that derivatives often are used as effective tools for managing exposures to market risk. Over the past several years, these instruments have been used to mitigate the potential losses to American businesses from significant changes in interest rates, foreign currency exchange rates, and commodity prices. [40]

On the other hand, derivatives have a dark side and can seriously be destructive. For instance, futures might be used as a platform for achieving gamblers' and speculators' ambitions. What makes futures very attractive for speculators is that it allows them to trade huge amounts of securities worth with a relatively minimal security deposit.

It can be argued that there is nothing wrong with the derivatives techniques themselves, as the problem is in the way market participants might employ them. For instance, forcing drivers by law to put seat belts while driving as a safety component might be regarded for some as an initiative to go faster because they feel

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39 Siems, Thomas, Policy Analysis: 10 Myths about financial derivative, available at: http://www.cato.org/pubs/pas/pa-283.html, Internet, last accessed at 25/05/2001.

40 Testimony of Steven Wallman (04/03/1997), Commissioner U.S. Securities & Exchange Commission, available at:http://www.sec.gov/pdf/report99.pdf, Internet; last accessed at 03/04/2001.

safe! And this ultimately increases the risk. By employing the same logic, the different types of derivatives may increase the degree of taking risk especially by those participants who would otherwise err on the side of caution. [41] What makes the situation worse, is that market participants are able to trade with large amounts of cash with very little up-front cash deposits. And this ultimately fosters the degree of risk that speculators are exposed to. In this context, it is worth remembering the bankruptcy of the Orange County, California, Barings Bank and the Long Term Capital Management, the last of which had to be rescued at a cost of $3.5 billion dollars. It was feared that the collapse of Long Term Capital Management could have had a disastrous effect on financial institutions around the world.

In 1997, derivatives also had numerous negative impacts on the East Asian financial economies. According to the Economic Strategy Institute:

> Derivatives play a two-fold role in the economy. They provide a useful role in hedging and risk management so as to facilitate capital flows to developing economies. At the same time, however, they create the conditions for the possibility for raising risk in relation to capital through leveraging and by dodging prudential regulatory safeguards. They can also make fixed exchange rate systems less stable, and then later quicken the pace and deepen the impact of devaluation once it occurs. This functions to increase the systemic risk in financial markets and raises the possibility of spreading contagion amongst economies. In the wake of the crisis they can make the process of post-crisis recovery policy making even more difficult.[42]

41 University of Exeter web site, available at: http://www.ex.ac.uk/~RDavies/arian/scandals/derivatives.html, Internet, last accessed at 23/05/2001.

42 Economic Strategy Institute, The Role of Derivatives in the East Asian Financial Crisis, available at: http://www.econstrat.org/dscrole.htm, Internet, last accessed at 25/05/2001.

6.3.3.3 Analysing Hedging Techniques from an Islamic Perspective

As mentioned in the beginning of this chapter, derivatives - as a conventional tool of risk management - are banned under the Islamic law. One of the main challenges facing Islamic finance and banking is the lack of risk management techniques. There is a desperate need for hedging techniques that are compliant with the different sources of Islamic contract law, and this is in order to manage various types of financial risks. Vogel and Hayes review the main points behind forbidding Muslims from dealing with conventional risk management techniques:

> Islamic legal rules, particularly bans on gharar and the sale of ayn bi-dayn, place myriad obstacles in the way of finding Islamic alternatives to these mechanisms. Islamic law may even be fundamentally opposed to the entire enterprise: hedging, the protecting of a profit position from risk, may offend the law's basic principle linking reward with risk; and derivatives, which transfer a risk from one person to another for a payment, seem to fall literally within the Prophet's prohibition of the sale of gharar, literally the "sale of risk". Derivatives can easily be used for gambling in various degrees, and the Quranic condemnation of gambling (maysir) may be viewed as so vehement as to rule out any consideration of the economic benefits of risk management.43

There are market participants that profit from derivatives by entering into transactions accompanied with high speculation. Many of these participants have the intent to gamble on a specific commodity or stock or currency, and this is unacceptable practice in Islam. In addition, it is impermissible to postpone pricing the underlying asset, the price must be agreed on spot basis. Furthermore, the market participants are able to buy and sell futures to make fast profits without necessarily having any involvement in the cash market, again this is impermissible from an Islamic point of view.[44] Derivatives are thought over as

43 Vogel, Frank, and Hayes, Samuel (1998), Islamic Law and Finance: Religion, Risk, and Return, Kluwer Law International, Massachusetts-USA, p. 154.

44 Naughton, Shahnaz and Naughton, Dordrecht (2000), Religion, Ethics and Stock trading: The Case of an Islamic Equities Market, Journal of Business Ethics, Jan, Vol. 23, Issue 2, p. 149 (145-159).

insurance, the whole idea of conventional insurance is rejected in Islam, and this is due to *gharar* and *riba* issues.

With regards to options, one of its main problems is they are designed to enable market participants to trade with a specific asset without owning it or taking possession of it. Most Muslim scholars agree on the prohibition of option trading, though the basis of their judgement differs from one scholar to another. Bacha summarizes a number of scholars' opinions on option trading:

> Ahmad Myhayyuddjn Hasan (1986) objects on two grounds, firstly, that maturity beyond three days as per khiyar-ala.shart (option of stipulation) is unacceptable. And second, that the buyer of an option is granted much more benefits than the seller and that "this is oppression and injustice. .. Mufti Taqi Usmani (1996) finds the sale of a stock with a put option to resell the stock to the issuer at a future date is unacceptable since a precondition is placed on the original sale of stock. .... Mohd. Obaidullah (1997) writes, "permissibility to conventional options is generally denied by a majority of scholars on the ground that these involve gharar and are primarily transacted for speculative gains.[45]

On the other hand, Elgari defends stock options provided that the seller of a call, and the buyer of a put, holds the underlying stock. He also recommends standardized European-style options that can only be exercised at expiration, to reduce flexibility and hence the potential for speculation.[46] It is worth mentioning that there are Muslim scholars who declare that there is nothing wrong with derivatives if they are used for risk hedging purposes and hence not for speculation purposes.

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45 Bacha, Obiyathullah (1999), Financial Derivatives: Some Thoughts for Reconsideration, International Journal of Islamic Financial Services, April – June, Vol.1, No.1, available at: http://islamic-finance.net/journal/journal1.pdf, Internet, last accessed at 25/03/2001, p. 17 (12-28).

46 As cited from: Naughton, Shahnaz and Naughton, Dordrecht (2000), Religion, Ethics and Stock Trading: The case of an Islamic Equities Market, Journal of Business Ethics, Jan, Vol. 23, Issue 2, p. 149 (145-159).

It is interesting to note that there are a number of financial contracts that are permissible from an Islamic perspective - even though they share some common characteristics with derivatives - especially future contracts. For instance, *salam* contract is a transaction whereby two parties are in agreement to the purchase/sale of a specific asset at a predetermined timing, and most important the buyer is obliged to pay the full amount to the seller in front. On the other hand, the seller agrees to deliver the asset according to the specification agreed on at the pre-agreed forthcoming date. In the case of futures, the contract involves the obligation to purchase (or deliver) a specific financial asset at a specified price and at some specific future date.

Although these two financial contracts might look similar, there are two main differences between them. In the case of *salam*, the buyer is required to pay the amount in full and in advance. In addition, the purpose and objective of *salam* contracts differs from futures. When *salam* as a contract was found in the days of the Prophet, its purpose was restricted to helping needy farmers and small businesses by providing some liquidity and financial sources for them. In the case of future contracts, the purpose is simply serving as a hedging technique from risk.

Last but not the least, it is worth indicating that Islamic banks, as other conventional banks, do face different types of risks and clearly need to manage these risks so they can ultimately reduce *gharar*. As for conventional banks, these banks already went through a long way and had tailored different types of tactics for managing risks i.e. derivatives. Yet, derivatives in Islam are without doubt banned due the previously mentioned reasons. Until these days, Islamic banks are still unable to "Islamize" the conventional risk tactics, due to the fact that such tactics embody *riba* and *gharar* and several other impermissible issues. To this moment, Islamic bankers and scholars are still unable to come with new risk management tactics that are compliant with the basic tenets of Islamic law. The end results; the lack of permissible risk management tactics is the challenge mostly faced by Islamic banks.

6.4 Sharing-risk Strategy

Sharing-risk strategy generally takes place at the time where two or more investors that have similar investment objectives decide to establish some sort of arrangement e.g. a "corporation". The capital pooled in this strategy is to be invested in a way that enables each investor to bear only a portion of the risk, and this is instead of bearing the total risk by one of them. In other words, the risk resulting from this initiative or arrangement is distributed among the partners according to a specific formula. With certain restrictions, the different sources of Islamic contract law support such arrangement. Sharing-risk strategy is one of very few strategies available for Muslim investors that can be used as a way of confronting risk. The most common contracts that are built on sharing-risk strategy are: *mudaraba*, *musharaka* and corporation.

The legal aspects of *mudaraba* and *musharaka* contracts already existed in the earliest Islamic period, and could be found in a developed form in some of the earliest Islamic legal works. These two contracts constituted an important feature of both trade and industry, and also provided a framework for investment. [47] In the case of the *mudaraba*, one party or more provides finance and the necessary funds for the business, while the other(s) provides entrepreneur-ship and management. The profit is shared in an agreed proportion. The loss is borne by the financiers only in proportion to their share in the total capital. As for *musharaka*, both parties contribute to the capital of the operation in varying degrees and agree to divide the net profits or losses in proportions that are pre-agreed on. Muslim scholars encourage Islamic banks and investment firms to implement

47 Udovitch, Abraham (1970), Partnership and profit in the medieval Islam, Princeton University Press, p. 261.

these two contracts due to their consistency with the Islamic law. The financial contracts that are based on risk-sharing i.e. *mudarabah* and *musharaka* are to a certain extent regarded as the alternative of *riba* based financing.

With regard to corporation, one of its definitions is as "a group of merchants or traders united in a trade guild."[48] Chapra argues that informal corporation between craftsmen and businesses was largely practiced in the early days of the Islamic society, and such corporation played a role in contributing to the realization of the goals of an Islamic economy. The author argues:

> With the emphasis of Islamic brotherhood, 'corporation' in its various forms to solve the mutual problems of producers, businesses and investors should receive considerable emphasis in an Islamic society.[49]

Western economies are also employing the concept of risk-sharing in several means. Freeman points out that early financiers used the idea of risk sharing as the basis of today's insurance industry. In addition, merchants and traders understood that while they could be damaged individually by the loss of one ship, they could rapidly become wealthy if they combined together and built fleets of ships that would not suffer excessively due to irregular wrecks. [50] More than a century ago, mutually owned life insurance firms in America and Europe were able to spread the benefits of risk-sharing to the masses, revolutionising millions of people's lives. Currently, the business of insurance is worth trillions of dollars, and it is hard to find a single country in the world

48 Merriam-Webster on-line Dictionary, available at http://www.m-w.com/cgi-bin/dictionary, Internet, last accessed on the 25/05/2001.

49 Chapra, Umar (1985), Towards a Just Monetary System, The Islamic Foundation, U.K., p. 75.

50 See Freeman, Dembo (1998), Seeing Tomorrow: Rewriting the Rules of Risk, Willey & Sons, Inc.

with no insurance companies and this is including Muslim countries. Still, the latter lines do not justify the permissibility of insurance business in Islam. There are several factors behind the prohibition of conventional insurance in Islam, the main ones refer back to *gharar* and *riba* issues. The question is what about those Muslims who want to ensure their homes, cars and any other asset? Is there a workable solution and alternative for Muslims to insure against unknown incidents?

Takaful is the Islamic alternative of conventional insurance, it is based on the concept of risk-sharing. The thrust of this arrangement is that a group of Muslims pool their financial resources to aid others in the event of any unexpected loss. The members involved in this arrangement are obliged to make periodic instalments. Consequently, the members also agree that in the case that one of them has suffered from a loss, a specific sum amount will be derived from each members account to cover the loss, and such an amount is regarded as a gift. In addition, the pooled funds are allowed to be invested only in permissible types of investments and any returns are to be distributed according to each share in the whole arrangement.

Mutual funds are also based on the concept of risk-sharing. The investor in mutual funds combines his own cash with a large number of shareholders. Usually these investors share a similar investment objective e.g. investing in growth stocks or investing in international financial markets. The ultimate goal of the different types of mutual funds is to diversify the risk over a large number of stocks, and to obtain professional investment management assuming this will enhance the possibility of reward.[51] Professional investment managers on behalf of the shareholders manage the purchased securities, and each investor holds a pro rata share of the portfolio.[52]

There are different types of mutual funds, and each of them has it own way of diversity. There are funds that focus on: one sector of the economy, or specific size of firms, or specific region, or specific type of securities …etc. Even though these funds are in a way focused on a specific aspect, however by breaking down the assets of each fund, it will be observed the extent these funds are diversified. For instance, Aberdeen Australia Equity Fund (IAF / AMEX)[53] is a country fund. The fund's objective is investing in long-term capital appreciation. Despite that the fund will invest at least 65% of its assets in equities listed on the Australian stock exchanges, this 65% is widely spread among different types of firms such as: - News Corporation Ltd, ANZ Banking Group Ltd, and Fosters Brewing Group Ltd. It is observed that each of the latter firms is related to a different sector. The Fund may also invest up to 10% of assets in unlisted Australian securities, and it may purchase options as a means of hedging portfolio risk. The end result; the assets of the fund are invested in many different securities to ensure diversification that ultimately leads to risk reduction.

The concept of mutual equity funds is to a certain extent based on *mudaraba* especially in the sense that the investor hands the cash to the fund manger, while the latter is

51 See Bogle, John and Duffuield, Jeremy (1982), Mutual Funds. In Friedman, Jack ed. (1982), Encyclopedia of Investments, Warren, Gorham & Lamont, Inc. Boston-USA.

52 Mutual Fund Investor's Center, available at: http://www.mfea.com/learn/basics.htm, Internet, last accessed 25/05/2001.

53 Closed-End Fund Center, available at http://www.closed-endfunds.com/, Internet, last accessed on the 25/05/2001.

responsible for all managerial and technical issues. There are certain types of mutual funds where the fund manager and the investor share the profits, and in case of loss, it must be borne by the investor. The latter is very similar to the concept of the *mudaraba* contract. However, revealing that mutual funds are very similar to *mudaraba* contracts is not enough to justify investing in mutual funds. The main problem is that conventional funds invest in securities that are involved in *riba* and impermissible businesses. For this purpose a special screening criteria has been set up to filter out all firms that violate the tenets of the different sources of Islamic contract law. Now, such screens certainly limit the selection of firms that the fund manager tends to invest in. Based on that, it might be argued that Islamic equity funds are more risky from their peers i.e. conventional ones.

There are other forms of stock investing that are based on the concept of sharing-risk. For instance, there is a sort of mutual type of investment called "Investment Clubs". The Security & Exchange Commission defines an "investment club" as follows:

> A group of people who pool their money to make investments. Usually, investment clubs are organized as partnerships, and after the members study different investments, the group decides to buy or sell based on a majority vote of the members. Club meetings may be educational and each member may actively participate in investment decisions.[54]

Investment clubs have recently grown tremendously. Such type of investment allows investors with limited financial resources to achieve the following objectives. First, they are able to invest in an increased number of stocks and most importantly with small sums of money. Second, they are able to diversify the risk as a result of investing in a larger

54 Security & Exchange Commission" of the USA, available at: http://www.sec.gov/investor/pubs/invclub.htm, Internet; last accessed on 03/03/2001.

number of stocks. Such clubs provide an appropriate platform for uninformed and inexperienced investors to learn from the professional ones.

Islamic banks and other financial institutions have still not enter the business of investment clubs, despite the concept of this type of investment is very similar to *musharaka* contract. In the latter contract, the shareholders share the profit and loss based on the size of their financial contribution(s). However, note that the creation of an investment club does not require the creation of a new company whereas *mushraka* does.

6.5 Summary

There are four common strategies for dealing with risk, these include: avoiding-risk, retaining-risk, transferring-risk and sharing-risk. The purpose of identifying these strategies is to achieve one of the ultimate objectives of the thesis, which is suggesting a number of tactics and methods designed in a way for reducing *gharar*.

Starting with the avoiding-risk strategy, it is observed that Muslim investors do not have much choice once their scope of investments is limited to securities associated with zero-risk. Investing in fixed income securities, preferred stocks and other similar securities is prohibited in Islam due to *riba* and *gharar*.

In regard to retaining-risk strategy, it is concluded that Muslims are able to avoid *gharar* by pursuing certain type of analysis, which help assessing both the proper value and the degree of risk associated with investing in a certain stock. Market participants that lack the required skills and capability are advised either to refer to an investment professional or to invest in an index fund that is compliant with the Islamic investment guidelines.

In regard to transferring-risk strategy, the different sources of Islamic contract law prohibit Muslims from employing hedging and derivatives tactics. There are several reasons for this prohibition, such as derivatives can be used for gambling purposes, or the idea of transferring risk from one participant to another for a payment is regarded as "sale of *gharar*", which has been prohibited by the Prophet, or even the idea of protecting profits against losses contradicts the concept of "profits must be accompanied with risk".

Last but not the least, risk-sharing strategy is regarded as a favourable method of confronting risk. The most two common contracts that are built on sharing-risk strategy are *mudaraba*, *musharaka*. The implications of employing these two contracts on contemporary conventional financial transactions are wide e.g. corporations, investment clubs, mutual funds and venture capital. Note that these transactions must be practised with in the boundaries of the basic tenets of Islamic contract law, for example, employing a screening criteria in the case of Mutual funds.

CHAPTER 7

CONVENTIONAL STOCK VALUATION MODELS

7.1 Introduction

The main purpose of chapter (6) was to clarify the different general strategies of dealing with exposed risk. One of these strategies is retaining-risk. In such strategy, the market participant is able to pursue a number of conventional valuation models for the purpose of reducing the risk resulted from stock investing. These different models include: Modern Portfolio Theory (MPT), Value Investing and conventional derivatives. One of the important conclusions derived from the chapter (6) is that derivatives; in their different types, are unlawful from an Islamic point of view. However, despite that derivatives are a transferring-risk strategy that does not mean that all financial contracts based on this strategy are impermissible. On the contrary, we have seen that *salam*, *isistna* and *bay al arbun* are all based on the concept of transferring risk. The problem with these three contracts (especially *bay al arbun* and *salam*) is that they are not widely (if at all) used by the different participants and parties who employ the concepts of Islamic banking and finance. This leaves Muslims (at least currently) with only two methods of reducing risk, which include: MPT and Value Investing. The purpose of this chapter is limited to explore these two models in detail. This ultimately will set the foundation for the chapter (8), which is named " Building an Approach for Managing *Gharar*". The main purpose behind chapter (8) is analysing MPT and Value Investing models from an Islamic perspective, and before doing that, it is important to explore these two models first.

7.2 Modern Portfolio Theory

Until 1952, the participants of stock markets employed a "classical" form of security analysis, and quantifying risk was not a central aspect among the analysis process. These participants believed that the process of security selection is based on analysis characterised as; "simple" and "honest" work, all of which would yield some "handsome rewards". [1] After 1952, the focus shifted towards a new way of security analysis called Modem Portfolio Theory (MPT).

The basic tenets of MPT were developed by Markowitz[2]. The latter person was the first to suggest so called "portfolio selection", which is based on the idea that there is trade-off between risk and reward, and by having a diversified portfolio the risk will be minimized. The foundation of MPT is that investors are rewarded for taking specific risks. [3] More precisely, the theory is concerned with how to combine stocks in a portfolio for the purpose of achieving the least risk possible consistent with return the investor's desire. The theory also demonstrates that "rational" investors are those who hold "efficient" portfolios, which can be achieved by maximising expected return for a given degree of risk, and by minimising risk for a given level of expected return.[4]

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1 See Hagin, Robert (1979), Modern Portfolio Theory, Dow Jones-Irwin, USA.

2 In 1990, Laureate Harry Markowitz has been awarded the Nobel Prize in Economics.

3 Walker J, Lewis (1998), Asset Allocation: Random Walks and Post-hoax Theories, Journal of Financial Planning, Apr, Vol. 11, Issue 2, Denver-USA, pp. 44-46.

4 See Hagin, Robert (1979), Modern Portfolio Theory, Dow Jones-Irwin, USA.

While measuring risk, MPT refers to the so-called "volatility", which is regarded as a measure of actual price changes during a specific time period. In the context of mathematics, volatility is the annualised standard deviation of daily returns during a specific period. MPT followers believe that there is a relationship between the volatility and uncertain outcomes. In other words, a higher standard deviation might imply more variable and uncertain returns.[5] There are several types of volatility, these types include: historical volatility, implied volatility, and realised volatility. Both historical and realised volatility are regarded as measures of observed price volatility. Implied volatility measures how variable option traders predict the price of the underlying asset over the life of the option. [6]

The implications of employing MPT extend to covering security valuation, performance measurement, portfolio optimisation and asset allocation. In order to determine each of the latter four implications, sufficient information is required. For instance, in the case of efficient portfolios, it is essential that every security be accompanied with the following information: -expected return, variance of return, and covariance of return. Hence, each one of these is dependent on other several types of information. [7]

5 See Fitzgerald, M (1998), Trading Volatility in Risk Management and Analysis, Vol. 2, Alexander, Carol (ed.), John Wiley & Sons, USA.

6 Ibid.,

7 Hagin, Robert (1979), Modern Portfolio Theory, Dow Jones-Irwin, USA, p. 261.

7.2.1 Types of Risks

Modern portfolio theory recognises two different types of risks: (1) unsystematic risk which is also called independent or diversifiable risk, and (2) systematic risk which is also known as non-diversifiable or market risk. [8] Systematic risk is defined as the risk associated with market dynamics and which is beyond the control of the market participant. [9] The followers of MPT state that the prices of stocks that posses a certain degree of systematic risk tend to move in the same direction of the stock market. Thus, a systematic relationship could be observed between the market and the stock prices. Systematic risk cannot be minimised through diversification; therefore, this type of risk might also be called non-diversifiable risk. This risk is dependent on several parameters related to the economy on a macro level, such as: interest rate, exchange rate, and political stability.

In regard to unsystematic risk, it can be reduced by diversification and therefore it can be controllable (on a relative basis) by the market participant. In addition, this type of risk is associated with the firm's operations on the micro level. In other words, the risk is dependent on issues directly related to the firm, such as management capability, customer preferences and labour strikes. Diversification can take several forms, for instance it might include: time diversification, asset diversification, sector diversification, size of firm diversification, and international diversification. Through portfolio diversification, the followers of MPT believe they are able to produce higher returns at lower risk. [10]

8 See Fielding, John (1989), Is Beta Better?, Management Accounting, Nov, Vol. 67, Issue 10, UK, pp. 38-41.

9 Cassell, Merrill (1999), Risk and Return, Management Accounting, Vol. 77, Issue 9, pp. 22-25, UK.

10 Peavy, John W III, Rauscher, Vaughn and Jo Mary (1994), Risk Management Through Diversification, Sep, Vol. 133, Issue 9, Trusts & Estates, Atlanta-USA, pp.42-47.

Malkiel goes further and explains that the key element of "true" diversification is dependent on having stocks in an investor's portfolio that are not all dependent on the same economic variables. [11] Some argue that diversification is not only crucial to efficient portfolio construction, but it is an important legal requirement for "fiduciaries". Peavy (ed.) al point that fiduciary must diversify a portfolio to fulfil the legal provisions. Nevertheless (according to same source) experience indicates that many "fiduciaries" are not aware of this important principle, which results in constructing portfolios that are not "effectively" diversified. The thrust of the author's theory is that poor portfolio performance caused by lack of diversification may harm the beneficiary and thus create "legal" liability to the "unsuspecting" fiduciary. [12]

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11 See Malkiel, Burton (1995), A Random Walk Down Wall Street; Including a Life-cycle Guide to Personal Investing, W. Norton & Company, Inc, USA.

12 Peavy, John W III; Rauscher, Vaughn and Jo Mary (1994), Risk Management Through Diversification, Sep, Vol. 133, Issue 9, Trusts & Estates, Atlanta-USA, pp.42-47.

7.2.2 MPT Methods of Measuring Risk

There are several mathematical equations or models tailored for measuring systematic risk. Ultimately, these models help in estimating the expected return on an equity investment. Systematic risk is measured by several quantitative models, these include: market beta, the arbitrage pricing model and regression or proxy models. Damodarn clarifies the definition of each of these models.

> In the capital asset pricing model, exposure to market risk is measured by market beta, which estimates how much risk an individual investment will add to a portfolio that includes all traded assets. The arbitrage pricing model and the multi-factor model allow for multiple sources of market risk and estimates betas for an investment relative to each source. Regression or proxy models for risk look for firm characteristics, such as size, that have been correlated with high returns in the past and use these to measure market risk. [13]

One of the most widely used tools derived from the MPT is the beta coefficient. [14] Beta coefficient measures the additional risk resulting from adding a particular asset to a well-diversified portfolio. Beta is measured broadly by comparing the change in the price of a particular stock for a period of time with a general stock market index. One of beta's main applications is helping market participants (especially investment managers) in constructing portfolios to match the risk preferences of investors, and to enable financial managers to estimate the cost of equity capital using the capital asset pricing model. [15]

Each value of beta has an indication, noting that it is preferable that these are taken on a relative basis. A beta = 0.5, is an indication that the stock is half as volatile (or risky) relative of market index. If beta's value equals 1.0, means the stock holds an average risk. In the case that beta equals 2.0, this indicates that the stock is twice as risky as the market

13 Damodarn, Aswath (2001), Corporate Finance, Wiley, USA., p. 179.

14 Blume, Marshall, Modern Portfolio Theory. In Friedman, Jack.(ed) (1990) , Encyclopedia of Investments, Warren, Gorham & Lamont, USA.

15 Fielding, John(1989), Is Beta Better?, Management Accounting, Nov, Vol. 67, Issue 10, London-UK, pp. 38-41.

index.[16] For the period from 1997-2000, the trend among US NASDAQ composite based stocks is a beta greater than one. There is no better example than "Yahoo" (yhoo) [17]. The one year stock price ranged from $ (24.12 - 250.06). The beta for the stock was equivalent to 2.17[18], which meant that the stock moved up 2.17 points every time the market moved up 1 point, which is a very high beta since its volatility in relation to the market is great. The other function of beta is measuring the projected return of a particular security. For instance, assuming that next year's market return equals 10 percent, and assuming that a stock having a beta of 2.00, will result in an expected rise in return of approximately 20 percent (2.00*10%).

There is no unified way of calculating beta among the market participants especially when it comes to selecting the "time horizons". Bernstein explores several ways of calculating beta and indicates that the general rule is that at least 20 observations are needed for statistical reliability. If quarterly returns are used, the author suggests a minimum of five years of data, and in the case of monthly returns, two to three years of data usually suffice. Professional investment entities such as Merrill Lynch and Value Line have their own way of calculating beta. In the case of Merrill Lynch, beta is calculated upon five years of monthly return information, using the Standard & Poor's stock price index as a proxy for the market. Betas are adjusted for a "regression" bias. [19]

16 Weston, Fred & others (1996), Essentials of Managerial Finance, The Dryden Press, USA.

17 According to Nasdaq.com, Yahoo is a global internet communications, commerce and media company that offers a comprehensive branded network of services to more than 120 million users each month worldwide.

18 Based on 2/31/2001 value, quoted from Nasdaq.com.

19 See Cohen, Jerome and others (1998), Investment Analysis and Portfolio Management, Irwin/McGraw-Hill, USA.

20 Ibid.

With regards to beta presented by Value Line, it is derived from weekly percent changes in the prices of stocks and in the New York Stock exchange Index over a period of five years, and in special cases, a smaller time period is adopted, but not less than two years. The evidence suggests that the longer the base time period is used the greater the amount of variance that will be explained by general market movements. [20]

The market return is measured by the average return of a large sample of stocks, such as the S&P 500 Stock Index. This index is widely used as a benchmark for the purpose of measuring the performance of constructed portfolios. S&P 500 Stock Index is one of the U.S. Commerce Department's primary economic indicators. There are several features behind the popularity of the S&P 500 index. These features set apart the S&P 500 index from the remaining market indicators. For instance, the stocks in the index represent more than 90 industry "sub-groups". In addition, the index is market value weighted rather than price weighted, which means that the price of each stock is multiplied by the number of outstanding shares. [21]

Despite the practitioner's and theorist's opposition towards beta, this quantitative tool still has extensive acceptance among many participants in the stock market. The defenders[22] argue that it was always understood that there is no guarantee that the future mirrors the past. In other words, there is not enough evidence confirming that the relation

20 See Fischer, Donald E (1995), Security Analysis and Portfolio Management, 6th edition, Prentice-Hall Inc, USA.

21 See Cohen, Jerome and others (1998), Investment Analysis and Portfolio Management, Irwin/McGraw-Hill, USA.

between the stock and the index will remain in the future as it already did in the past. However, it can be reasonably assumed that a stock with histories of high price fluctuations will have a less predictable future performance than a stock with a past performance that has been most stable. The MPT followers accept the idea that some stocks are relatively more volatile (riskier) than others.

After exploring the fundamentals of beta, it is worth indicating that this quantitative tool holds a number of shortcomings. People who are against using beta argue that the most a market participant can get from beta is using it as a "relative" risk measure. In other words, beta is a measure of how a stock is likely to move relative to an overall stock index, however, it does not give an indication of the stock's unique volatility. There are scholars[23] who argue that the simplifying assumptions of MPT do not conform with reality. Furthermore, a "fully" diversified portfolio is impossible to construct in the real world. Regarding this point, it is argued that in the case of non-diversified portfolios, a stock with a beta of 1 might mean it would contribute twice as much volatility as the broader stock market. The other major issue is that beta is highly dependent on the benchmark selection and its performance. Therefore, it is important to select an appropriate index and ensure that such an index represents the market in broad means.

There are scholars who question the validity of beta in the sense of its ability to predict future stock returns.[24] Malkiel discuss this issue in further detail, he asserts that:

23 See Chatterjee, Sayan (1999), Toward a Strategic Theory of Risk Premium: Moving Beyond CAPM, Academy of Management. The Academy of Management Review, Jul, Vol. 24, Issue 3, Mississippi State-USA., pp. 556-567.

24 See Fama, E. (1997), Market Efficiency, Long-term Returns, and Behavioural Finance, Journal of Financial Economics, Vol. 49, Switzerland, pp. 283-306,

> The actual relationship between beta and rate of return does not correspond to the relationship predicted in the theory. Moreover, the relationship is undependable in the short run and has even failed to work for very long periods. Some analysts doubt if betas have ever been useful predictors of future returns. [25]

In addition, on the technical side, beta calculation requires market prices on assets, which makes it difficult to apply for non-traded stocks or for stocks that have only been traded for a short period of time. Last but not the least, beta in the case of mutual funds, might not adequately serve the market participants' purpose when it comes to measuring the performance and personal skills of different fund managers for similar funds.

25 Malkiel, Burton (1995), A Random Walk Down Wall Street; Including a Life-cycle Guide to Personal Investing, W. W. Norton & Company, Inc, USA, p. 275.

7.3 Value Investing Approach

The second conventional valuation model of stocks is the "Value Investing" approach, the followers of this approach are usually called "value investors" and sometimes referred as "fundamentalists", "intrinsic value buyers" and "private market value buyers." [26] The basis of Value Investing is derived from what is called fundamental analysis. The foundation of this analysis is set up by the various editions of Security Analysis; authored by Dodd and Graham.[27] The followers of this approach believe in certain values that are different from the ones suggested by MPT. One of the central distinctions between MPT and Value Investing approach is the issue of price. Value investors believe that "value" is not "price", "valuation" is not "pricing", and "valuation models" are not "pricing models". [28]

Value investors analyse the different "fundamentals" of a potential firm, and this is in order to determine the proper value of the firm. Whitman characterises Value Investing as the process of buying "what is" "safe" and "cheap". The author illustrates:

> [What is] refers to the use of analytic techniques that concentrate on the known situation of a company – the quality and quantity of sources in the company, with little or no concentration on forecasts of relatively near term flows… [Safe] is measured mostly by strong financial positions and by the quality of resources. [Cheap] means an acquisition price of a common stock appears to represent a substantial discount from what the common stock would be worth were the company a private business or a take over candidate. [29]

26 Cole, Stephen, In Search of Value, CA Magazine, May, Vol. 133, Issue 4, Canada, pp. 45-46.

27 Graham, Benjamin and Dodd, David (1996), Security Analysis, Classical edition (1934), McGraw-Hill Book Company.

28 Global Value Investing with Stock Valuation, available at: http://www.numeraire.com/value..htm, Internet, last accessed at 13/1/2001.

29 Whitman, Martin (1999), Value Investing, John Wiley & Sons, Inc., P. 6.

The way value investors define risk is very different from the way the followers of MPT define it. For instance, value investors consider beta as a "myth" especially when it comes to avoiding stocks with high betas.[30] Buffet asserts the following:

> Train offered the example of being able to buy $1 worth of value in the market for 75 cents. Suppose the price declined so that the same $1 worth of value could be had for 50 cents while at the same time the general market remained unchanged. Here beta has increased but so has opportunity and safety. To reject opportunity because of an increasing beta would be absurd.[31]

Value investors believe that the usefulness of beta is restricted to theoretical studies, and beta is "irrelevant" when it comes to assessing risk in the real world.[32] Value investors relate risk to intrinsic value. Buffet defines risk as:

> ... the possibility of harm and injury. And that is a factor of the "intrinsic value risk" of the business, not the price behavior of the stock. The real risk, Buffet says, is whether after-tax returns from an investment "will give him (an investor) at least as much purchasing power as he had to begin with, plus a modest rate of interest on that initial stake.[33]

In regard to "diversification", both MPT and Value Investing approach differ dramatically. As mentioned before, MPT use diversification as a way of reducing unsystematic risk. In contrary, value investors do not classify different types of risk. They are only concerned with risk when it comes to "intrinsic value". Further more, value investors are against the idea of excessive diversification. Graham asserts that a portfolio consisting of "high-grade common stocks" is one with the following four characteristics:

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30 See Hagstrom, Robert (1994), The Warren Buffet Way, John Wiley & Sons Inc.

31 Ibid., p.28.

32 Wilcox, Jarrod (2000),Better Risk Management, Journal of Portfolio Management, Summer, Vol 26, Issue 4, New York, pp.53-64.

33 Brandes, Charles (1997), Value Investing Today, McGraw-Hill., p.30.

1- There should be adequate not excessive diversification….
2- Each company selected should be large, prominent and conservatively financed …
3- Each company should have a long record of continues dividend payments …
4- The investor should impose limit on the price he will pay for an issue in relation to its average earnings over, say, the past seven years …[34]

Hagstrom attempts to clarify the differences between the approach employed by each of the major three players of Value Investing, these players include: Graham, Fisher and Buffet. [35] Fischer believes that "superior" firms are those with both; most capable management and high potential businesses. In addition, Fisher always argued that analyzing financial reports is not enough to justify an investment decision. In regard to Graham, he is interested in purchasing "under valued" stocks, while Fisher is interested in "intrinsic value" over the long term. Unlike Graham, Fisher would go to great lengths. Graham believed in employing quantitative methods on measurable factors: fixed assets, current earnings and dividends. However, Fisher believed in qualitative tactics such as interviewing of customers, competitors or managers, and that is for the purpose of uncovering bits of information that might improve the participant's selection process. Buffet's investment style is a combination of both the Fisher and Graham styles. In other words, Buffet is focused on qualitative understanding of the business and its management, which is taught by Fisher, with a quantitative understanding of price and value, which is taught by Graham.

34 Whitman, Martin (1999), Value Investing: A Balanced Approach, John Wiley & Sons. Inc. , p. 79.

35 See Hagstrom, Robert (1994), The Warren Buffet Way, John Wiley & Sons, Inc.

7.2.1 Value Investing Multiples

For the purpose of evaluating the intrinsic value of a potential firm, value investors employ different types of "multiples" such as "price multiple" (P/E), "book multiple" (P/B) and "sales multiples" (P/S).

In regard to P/E, it can be calculated in several ways, the most common one is by dividing the closing price of the stock over the reported earnings of the most recent year. Other than that, P/E ratio can be calculated by taking the middle value of a firm's P/E ratios over the past 10 years, with certain statistical adjustments. It is also possible to compare the P/E of a particular stock with the P/E of a specific index, this is called "relative" P/E ratio. [36]

The price multiple ratios are regarded as one of the most intuitive ways of evaluating the intrinsic value of firms. [37] The ratio helps value investors in assessing bargains or overpriced firms.[38] Damodraran clarifies the reasons of why the P/E is widely employed, the author asserts:

> First, it an intuitively appealing statistic that relates the price paid to current earnings. Second, it is simple to compute for most stocks and is widely available, making comparisons across stocks simple. Third, it can be a proxy for a number of other characteristics of the firm including risk and growth. [39]

Each result of P/E valuations provides the market participant a particular indication. Fischer mentions that low P/E ratios are typically associated with low "earning growth",

36 See Hagstrom, Robert (1994), The Warren Buffet Way, John Wiley & Sons, Inc.

37 Bernstein, Peter and Damodraran Aswath (1998), Investment Management, John Wiley & Sons, Inc., p.195.

38 Fischer, Donald (1995), Security Analysis and Portfolio Management, 6th edition, Prentice-Hall, Inc., p. 261.

39 Damodraran, Aswath (1996), Investment Valuation, John Wiley & Sons, Inc., p.291.

and high P/E ratios are associated with high earnings growth.[40] Graham and Dodd in the first edition of Security Analysis; which was authored in 1934, clarify that one of the conditions of investing in common stocks is having a "reasonable" ratio of market price to average earnings, and at that time, the reasonable ratio did not exceed 16.[41] Noting that in the following editions of Security Analysis, the minimum of the reasonable (P/E) ratio kept changing.[42] Having said that, it is worth indicating that there are market participants that pay higher prices i.e. higher P/E, in order to own "high growth" stocks, and hence, these participants are not regarded as value investors. [43]

After mentioning the fundamentals of P/E ratio, it is worth mentioning that there are several problems associated with the calculation of such ratio. According to one scholar:

> First, PE ratios are not meaningful when the earnings per share is negative. While this can be partially overcome by using normalized or average earnings per share, the problem cannot be eliminated. Second, the volatility of earnings can cause the PE ratio to change dramatically from period to period. For cyclical firms, earnings will follow the economy, whereas the prices reflect expectations about the future. Thus it is not uncommon for the PE ratio of a cyclical firm to peak at the depths of a recession and bottom out at the peak of an economic boom. [44]

The second important multiple is called "book value multiple" (P/B). The purpose of this multiple is building on a relationship between the "price" of the stock and the "book value" of the firm. It is observed that the book value multiple is driven by accounting rules. The central idea behind this multiple is focusing on the "original" cost of the asset.

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40 Damodraran, Aswath (1996), Investment Valuation, John Wiley & Sons, Inc., p.291.

41 Garaham, Dodd and Graham Benjamin (1996), classical edition (1934), Security Analysis, McGraw-Hill., p.453.

42 Nicholson, S.F. (1960), Price-Earning Ratios, Financial Analysts Journal, July -August, pp. 43-50.

42 Garaham, Dodd and Graham Benjamin (1996), classical edition (1934), Security Analysis, McGraw-Hill., p. 493.

4 3 Damodraran, Aswath (1996), Investment Valuation, John Wiley & Sons, Inc., p. 307.

And the latter is different than the market value of an asset, which reflects its earning power and expected cash flows. Since the book value on an asset is based on the original cost, it might deviate significantly from market value especially if the earning power of the assets has increased or declined significantly since its acquisition.[45]

A number of shortcomings are associated with calculating P/B ratio. First, this ratio is influenced by accounting decisions such as depreciation. And when accounting variables vary across firms, the P/B ratios are not regarded as useful indicators. Secondly, a similar statement can be made when it comes to comparing P/B ratios across countries, especially if each country has different accounting standards. Thirdly, the results of P/B ratios do not carry much meaning in the case of service firms i.e. firms that do not have significant fixed assets. [46] Hooke also asserts that P/B ratio fails to include the extra value of the business as a going concern. In addition, such ratios fail to write up any increases in tangible assets e.g. real estate. Nevertheless, the author mentions that P/B ratios might be used for the purpose of evaluating troubled businesses, where the value of liquidation is usually based on the original price of the assets.[47]

In recent years analysts shift their focus to so called "sale multiple" ratio. The ratio is calculated by dividing the price of the stock over the total sales of the firm. This ratio is attractive especially when it comes to those firms with negative earnings. The advantage of this ratio is that it is unlike earnings and book value multiples, sale multiple ratios are

45 Damodraran, Aswath (1996), Investment Valuation, John Wiley & Sons, Inc., p.318.

46Ibid., p. 319.

47 Hooke, Jeffrey (1998), Security Analysis on Wall Street, John Wiley & Sons, Inc., p. 273.

not influenced by the accounting decisions and variables, and most important, revenues resulted from sales are difficult to manipulate.

One of the recent suggested models that is related to Value Investing is called "Cornell model". The model discounts future cash flows of any of the Dow components and match up the result to current public market prices. If the value of the discounted cash flow (DCF) is higher, then the market is expensive; if it's lower the target is cheap. An emphasis is placed on determining the discount rate and in particular the growth factor. Hence, increasing growth rates lead to higher values. [48]

48 Cole, Stephen (2000), In Search of Value, CA Magazine, Vol. 133, Issue 4, Canada, pp. 45-46.

7.2.2 Long Term Investing

As previously asserted, value investors believe in holding stocks for long term periods. Williams highlights the importance of holding a security for long-term periods. [49] The author asserts that the longer the market participant holds the stock, the dividends become more important, and obviously less important when the stocks are sold. Value investors aim to earn suitable long-term income, and this is best achieved by "Buy-and-hold" strategy. Buffet asserts the following:

> Your goal as an investor should be simply to purchase, at a rational price, a part interest in an easily understandable business whose earnings are virtually certain to be materially higher, five, ten, and twenty years from now [50]

Buffet also believes that "risk" is strongly linked with the investor's time horizon. In other words, if an investor buy's a stock today with the intention of selling it tomorrow, then according to Buffet, the investor has entered into a risky transaction. Once the focus of the investor is limited to predicting stock prices in short-term periods, is no greater than the predicting the toss of a coin. [51]

Siegel in his book Stocks for the Long Run[52] performed different statistical tests on historical data related to the U.S security markets. The period chosen for the study is approximately 200 years (1802-1997). The author compares the range of variation of "real" return on stocks, long-term bonds and Treasury bills. In their best single year,

49 Williams, John (1997), The Theory of Investment Value, Fraser Publishing Company, Vermont-USA. p.4.

50 Hagstron, Robert (1999), The Warren Buffet Portfolio, John Wiley & Sons. p.16.

51 Ibid., pp. 29-30.

51 Siegel, Jeremy (1998), Stocks for the Long Term, McGraw-Hill.

stocks delivered a real return of 67%, while in their worst year returned -39%, the difference in returns equals 106 percentage points. The one-year range for bonds is far smaller at 57 points, and the one-year range for Treasury bills is smaller again at 40 points.

Siegel also observed a similar pattern one he compared standard deviations of annual real returns. In the 1802-1997 data, the standard deviation of the annual return is 18% for stocks, 9% for bonds, and 6% for bills. [53] In short term basis, as shown in table (7.1), stocks are unquestionably riskier than bonds or bills. In every five-year period since 1802, however, the worst performance in stocks is –11 percent per year, it was only slightly worse than worst performance in bonds or bills. For ten year holding periods, the worst stock performance was better than for bonds or bills. [54]

Table (7.1) [55]
Maximum and Minimum Years Holding Period Returns (1802-1907)

	Type of Security		
Years of Holding Period	Stocks	Bonds	T-Bills
1- year	66.6%:-38.6%	35.1%:-21.9%	32.7%:-15.6%
2- year	41.0%:-31.6%	24.7%:-15.9%	21.6%: -15.1%
5 -year	26.7%:-11.6%	17.7%:-10.1%	14.9%:-8.25%
10- year	16.9%:-4.1%	12.4%:-5.4%	11.6%:-5.15%
20- year	12.6%:1.0%	8.8%:-3.1%	8.3%:-3.0%
30- year	10.6%:2.6%	7.4%:-2.0%	7.5%:-1.5%

53 Campbell, John (2000), Investors Should Bear in Mind that Equities are Risky, Pensions & Investments, Nov 27, Vol. 28, Issue 24, Chicago-USA, pp. 62-63.

54 Siegel, Jeremy (1998), Stocks for the Long Term, McGraw-Hill.

54 Ibid., p.27.

Table (7.2) shows the percentage of times in which the returns on stocks outperform bond or bill returns. It is observed that when the holding period increases, stock outperform both bonds and bills nearly 80 percent of the time. For 20-year horizons, it is over 90 percent of the time; and over period 30-year horizons, it is virtually 100 percent of the time. [56] In this context, Campbell asserts the following:

> It would appear that stocks are no riskier than bonds and bills for long-term investors who can hold their positions for at least a decade. Similar patterns are visible in some international markets, although reliable long-term data are harder to come by overseas. [57]

Table (7.2) [58]
Holding Period Comparisons: Percentage of Periods When Stocks Outperform Bonds and Bills

Holding Period	Time Period	Stocks outperform Bonds	Stocks outperform T-bills
1 Year	1802-1996	60.5	61.5
	1871-1996	59.5	64.3
2 Year	1802-1996	64.9	65.5
	1871-1996	64.8	69.6
5 Year	1802-1996	70.2	73.3
	1871-1996	72.1	75.4
10 Year	1802-1996	79.6	79.6
	1871-1996	82.1	84.6
20 Year	1802-1996	91.5	94.3
	1871-1996	94.4	99.1
30 Year	1802-1996	99.4	97.0
	1871-1996	100.0	100.0

One of the major findings of Siegel's historical calculations, is that stocks, in contrast to bonds or bills, have never offered the investors a "negative" real return for periods that are over 17 years. The author concludes:

56 Siegel, Jeremy (1998), Stocks for the Long Term, McGraw-Hill., p.27.

57 Campbell, John (2000,), Investors Should Bear in mind that Equities are Risky, Pensions & Investments, Nov 27, Vol 28, Issue 24, Chicago, p.63.

58 Siegel, Jeremy (1998), Stocks for the Long Term, McGraw-Hill., p.28.

Although it might appear to be riskier to hold stocks than bonds, precisely the opposite is true: the safest long-term investment for the preservation of purchasing power has clearly been stocks, not bonds.[59]

59 Siegel, Jeremy (1998), Stocks for The Long Term, McGraw-Hill., p.26.

CHAPTER 8

BUILDING AN APPROACH FOR MANAGING GHARAR

8.1 Overview

The end purpose of this chapter is to suggest to Muslim investors a number of tactics and modes that can applied for the purpose of *gharar* reduction in stock investing. To achieve this purpose, a number of parameters need to be considered. First, the suggested tactics must be consistent with the different sources of Islamic contract law. Second, the focus of these suggested tactics is limited to reducing *gharar*. The focus of *gharar* would be argued to be narrow if, for example, the tactics used to avoid *gharar* would expose the investor to greater incident of *riba*. However the presence of the first requirement obviates against this. Third, these tactics are associated with simplicity, and that is in order to enable those Muslim investors; with a limited to average degree of financial knowledge, to employ these tactics with minimal problems.

Before pursuing the analysis, the following lines present a logical and religious justification of the way Muslim investors need to pursue when it comes to reducing *gharar* in terms of stock investing. In this context, there is a need to refer to two central theories derived from the science of Philosophy. These are Rational Choice Theory and the Causality Theory. This approach is undertaken by Al-Suwailem's well-cited paper "Decision Under Uncertainty: An Islamic Perspective". The author attempts to link the values of Islam with both the Causality Theory and the Rational Choice Theory. [1]

1 Al-Suwailem, Sami (2000), Decision Under Uncertainty: An Islamic Perspective, Internet, available at: http://www.islamic-exchange.com, last accessed at 15/05/2001.

8.2 Rational Choice Theory

Knight argues that there are events where the future outcome is uncertain, or even extremely probable, or perhaps only "contingent", but if the numerical probability of its occurrence is known, conduct in relation to that particular event in question may be arranged "intelligently".[2] One of the thesaurus for "intelligently" is "rationality", and this latter term is widely evident in literature pertaining to the topic of making decisions under uncertainty. According to Elster, rationality is: " beliefs, preferences, choices or decisions, actions, behavioral patterns, persons, even collectives and institutions."[3] Zey also put forward a number of definitions of "rationality". He asserts that the most common meaning is "reasoned action" of any type, he also asserts that:

> one is rational if, after considering all of one's concerns – moral, altruistic, familial, narrowly self-interested, and so forth – one then chooses coherently in trading each off against the other, or even in refusing to make certain trade-offs. [4]

The principles of The Rational Choice Theory (RCT) are derived from Neoclassical Economic Theory, Utility Theory and Game Theory. [5] The thrust of RCT concludes that the foundation of rational selections is the "hierarchy" of preferences (values, utilities) that promises the highest "net benefit" to the actor and the highest probability of its occurrence.[6] By modifying this argument and making it consistent with theme of the thesis, the result is as follows. For Muslim investors, the foundation of a rational selection of stocks is based on the basic values of property ownership in

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2 Knight, Frank (1985), Risk, Uncertainty and Profit, University of Chicago Press, Chicago-USA., pp. 212-213.

3 Elster, Jon (1979), Ulysses and the Sirens, Cambridge University Press, Cambridge-U.K., p.1.

4 Zey, Mary (1998), Rational Choice Theory and Organizational Theory: A Critique, SAGE Publications, Inc, London-U.K., p.14.

5 See Levi, Margret, Cook, Karen, Obirn, Jodi and Faye Howard (1990), Introduction: The Limits of Rationality. The Limits of Rationality, ed. Karen, Shweers Cook and Margert, Levi, University of Chicago Press, Chicago-USA., pp. 1-8.

6 Zey, Mary (1998), Rational Choice Theory and Organizational Theory: A critique, SAGE Publications, Inc, London-U.K., p.2.

Islamic contract law, and one way of achieving the highest net benefit is by avoiding stocks that consist of *gharar*. This can only be achieved by employing several tactics and strategies in advance to investing in a particular stock.

Imam Ash-Shafi; one of the four main Islamic *fiqh* schools, links rationality with the ownership of property. According to this source, the owner of a property or an asset is described as one of the following four cases:

> 1- To be rightful in his religion and property and this is the rational person whose affairs are permissible and whose contracts and acts are valid.
> 2- To be corrupt in his religion because he shows explicit sin, and corrupt in his property by wasting it in a transaction involving excessive fraud or spending it in an unlawful matter. ...
> 3- To be rightful in his religion but corrupt in his property by spending it extravagantly.
> 4- To be rightful in his property but corrupt in his religion.[7]

Among the latter four cases the thesis is concerned with the first one, which indicates that from an Islamic perspective a rational person is to be rightful in his religion and property, and this can be achieved by performing only *halal* acts and contracts. There is no doubt that one of these *halal* contracts is confirming that the investor's income or return from stock investing excludes *gharar*. Now the critical question is how to do that? In other words, what makes a Muslim investor regarded as a rational investor, aware that the focus of this thesis is limited to *gharar*? More specifically, what are the causes of *gharar* in stock investing? Answering these questions requires tackling the "profits" in the context of Causality Theory.

7 Al-Thamali, Abdullah (1998), The Place of Islamic Economy between Reason and Revelation, Contemporary Jurisprudence Research Journal, Edition number 24 (1998-99), Saudi Arabia., p.81.

Al-Suwailem, in accordance with the suggested relation between the cause and result, bestows several verifications that are extracted from the different sources of Islamic contract law. He pictures the casual relationship "*x* causes y" in three ways. The first is based on explicit statements derived from the Quran and the *Sunna*. The second occurs by employing "experimental evidence" whereby different statistical and quantitative approaches are undertaken. The third verification is related to "intuitive judgment", whereby an agent would evaluate the possibility of different scenarios to indicate the one that is most likely to take place as a cause of a certain effect.[8]

Knight conjoins generating profits with uncertainty, he argues that the root cause of justification of profit is uncertainty, and hence, profit is originated not from change itself but from the "unpredictability" of change, which makes the precise rational judgment of future change and profits difficult to achieve.[9] The author's conjecture is viewing profit as a kind of "risk premium" that is likely to transpire the different kind of economics system.[10]

Hutton explains how profits are justified among the different economics schools. He argues that in the case of the Capitalism, profits are a justified reward for risk taking or uncertainty. However in the case of Marxism, profits are a measure of "exploitation" of the working class.[11] Ibn Khaldun pictures profits in means of commerce. He illustrates that most trading practices and methods are "tricky" and designed to obtain the (profit) margin between the purchase prices and sale prices.

8 Al-Suwailem, Sami (2000), Decision Under Uncertainty: An Islamic Perspective, Internet, available at: http://www.islamic-exchange.com, last accessed at 15/05/2001.

9 Hutton, John (1979), Mystery of Wealth, Stanley Thornes Publishers Ltd., U.K., p.213.

10 Ibid., p.213.

11 Ibid., p.211.

The Arab scholar justifies why the law permits cunning in commerce because it contains an element of "gambling".[12] Except for the case of the Marxism economic school, it can be concluded that the others tend to justify profits by uncertainty; as in the case of capitalism, and even Islam tends to indirectly justify profits by uncertainty however with a different degree. Note that the outcome of gambling is associated with a great deal of uncertainty.

So the question is how to solve the dilemma of generating permissible profits in the light of uncertainty. The famous Muslim scholar Al-Shatibi argues that an individual will implement the cause in a proper manner if he does not focus on the uncertain outcome. Instead he might implement the cause improperly, or seek inappropriate means, leading to "dishonesty" and "unethical" behavior.[13] In this context, Knight focuses on the issue of "reasoning" and provides - to a certain extent - a similar argument to the one suggested by Al-Shatibi. Knight argues that:

> That the doctrine of ignorance or "insufficient reason" is untrue to the feelings of unsophisticated intelligence. We do not merely feel that we know no reason why the coin shall fall heads or trails; we know in a positive sense that there is no reason, and only under this condition do we make the probability judgment with any confidence.[14]

Al-Suwailem takes the argument further and attempts to differentiate between gambling and investment on the basis of causality theory. He argues " investment is a decision to implement appropriate causes, while gambling is to take pure chance."[15] Subsequently, Al-Suwailem argues the following:

> It is shown that *gharar* stems from individual's passive behavior and reliance on chance. By establishing the principle of causality, Islamic teachings attack

12 Dawoos N. J. (1981) Ibn Khaldoun The Muqaddimah An Introduction to History, Princeton University Press, Princeton-USA., p.300.

13 As cited from Al-Suwailem, Sami (2000), Decision Under Uncertainty: An Islamic Perspective, Internet, available at: http://www.islamic-exchange.com, last accessed at 15/05/2001.

14 Knight, Frank (1985), Risk, Uncertainty and Profit, University of Chicago Press, Chicago-USA., p222.

15 Al-Suwailem, Sami (2000), Decision Under uncertainty: An Islamic Perspective, Internet, available at: http://www.islamic-exchange.com, last accessed at 15/05/2001.

> *gharar* and similar social ills at their roots. Active behavior not only improves individual's decision making, it also leads to avoidance of prohibited contracts, such as *gharar* and *riba*. Islamic economics, therefore, is an integral part of a comprehensive system that guides to optimal behavior in all aspects of life. [16]

The end result of the previous arguments is that actors, who focus on the causes in a proper manner and those who pursue rational reasoning, are likely to reduce the possibility of being involved in gambling and high uncertain outcomes. By applying this same argument in the context of stock investing, it is possible to conclude the following. In order for investors to avoid *gharar* they should not rely on pure chance in achieving the desired profit or return. Contrary, the investor should focus on the causes that lead to profit that is excluded from *gharar*. Most importantly, the study of these causes must be within the boundaries of Islamic law. The critical question is: what are the causes that the Muslim investor needs to focus on in order to earn *halal* profit; and here our concern of *halal* profit is limited to the avoidance of *gharar*.

Unfortunately, there are no specific stock valuation models and tactics that are tailored especially for Muslim investors and can be used for *gharar* reduction. However, there are different conventional valuation models that are widely used in contemporary stock investing truncations. The thesis presumption is that part of these valuation models can be successfully used for *gharar* reduction. Offering these selected tactics to Muslim investors will help in avoiding prohibited contracts i.e. *gharar*. It is important to assure that the employment of these tactics is far from guaranteeing that *gharar* will be excluded from a certain stock. However, once Muslim investors pursue these tactics, these Muslims will certainly avoid counting on

16 Al-Suwailem, Sami (2000), Decision Under Uncertainty: An Islamic Perspective, Internet, available at: http://www.islamic-exchange.com, last accessed at 15/05/2001.

chance to achieve the desired outcome, which is the essence of gambling and *gharar*.

Al-Suwailem states the following:

> Muslim scholars call the hope to achieve a desired objective without implementing appropriate causes: *tamanni*. When it is combined with proper causes, it is called *raja*'. *Tamanni* therefore leads an individual to ignore natural means, and rely on blind luck. After uncertainty is resolved, such hope passes away, and the individual faces the reality without real attempt to influence it. Such hope therefore deceives the decision maker into behaving irrationally. [17]

17 Al-Suwailem, Sami (2000), Decision Under Uncertainty: An Islamic Perspective, Internet, available at: http://www.islamic-exchange.com, last accessed at 15/05/2001.

8.3 Analyzing Conventional Stock Valuation Models and Tactics from an Islamic Perspective

Malkiel asserts that the logic of the firm-foundation theory (equivalent to Value Investing) is "quite respectable" and can be illustrated best with common stocks.[18] Value investing approach is more focused on value rather than the price; as the case of the modern portfolio theory. The famous value investor Buffett argues that the central issue for the investor is the asset and what businesses will do. On the other spectrum, the speculator's prime concern is forecasting what the price will do independent of the business. [19] In this context, it is worth referring to the original definition of both terms value and price. Value is defined as: "An amount, as of goods, services, or money, considered to be a fair and suitable equivalent for something else; a fair price or return."[20]. Price is defined as the "amount as of money or goods, asked for or given in exchange for something else." [21] The central distinction between the previous two definitions is the term "fair". One of the synonyms of "fair" is "justice". Justice in Islam is the most important criterion for judging the degree of Islamization of a Muslim society, and Islamic law serves as the basis for Justice. [22] As mentioned in one of the verses in the Quran:

> … Give full measure and full weight, in justice. We task not any soul beyond its scope. And if ye give your word, do justice thereunto, even though it be (against) a kinsman; and fulfil the covenant of Allah. This He commandeth you that haply ye may remember.[23]

18 Malkiel, Burton (1999), A Random Walk Down Wall Street, W. W. Norton & Company, p.30.

19 Emerson, Henry (1997), Outstanding Investor Digest, August 8, available at: www.oid.com, last accessed 03/03/2000, p.14.

20 The American Heritage Dictionary of the English Language, available at: http://www.dictionary.com/c/s.dll/dict.pl?term=value, Internet, last accessed at 15/05/2001.

21 The American Heritage Dictionary of the English Language, available at: http://www.dictionary.com/cgi-bin/dict.pl?term=price, Internet, last accessed at 15/05/2001.

22 Chapra, Umer (1999), Islam and Economic Development; A Discussion with in the Framework of Ibn Khaldoun's Philosophy of History. Proceedings of the Second Harvard University Forum on Islamic Finance, Harvard University, Boston-USA, pp. 23-28.

23The Quran: An'am [6:152].

There are Muslim scholars who attempt to link between the intrinsic value and the *manafa*, which literally means (utility) value. These scholars argue that utilization value is an intrinsic value that is not subject to the speculations of the people.[24] At the same time, as coined by Benjamin Graham, the phrase "intrinsic value" is central in the Value Investing approach.[25] Intrinsic value can be regarded as one of the major common issues between Value Investing and the basic tenets of Islamic contact law. In the case of Value Investing, the purpose of using the adjective intrinsic is to emphasize the distinction between value and current market price.

Objectives of Islamic Law (*maqasid al-shariaa*) is a central concept that has been excessively referred to in the writings of the Muslim scholars. This concept can be applied for the purpose of indicating the permissibility of contemporary issues. It is very similar to "cost-benefit" analysis. [26] The best example of this concept is the case of banning gambling and alcohol drinks in the Quran.

> They question thee about strong drink and games of chance. Say: In both is great sin, and (some) utility for men; but the sin of them is greater than their usefulness. And they ask thee what they ought to spend. Say: that which is superfluous. Thus Allah maketh plain to you (His) revelations, that haply ye may reflect. [27]

God in this verse indicates that strong drinks and games of chance have utility for human being, nevertheless, the wrongdoing of consuming and practicing them is larger than their usefulness. The same argument could be applied in the case of investing in high-risk stocks, as investing in these stocks might probably generate fast

24 Al Zahrani, Muhammad (1993), Aspects of the Theory of Value According to the Islamic Jurists, Contemporary Jurisprudence Research Journal, Vol. 5, Edition number 18, Saudi Arabia., p. 38 (35-47).

25 Carbonara, Peter (1999), What is the Intrinsic Value?, Money, Jun, Vol. 28, Issue 6, New York-USA, pp. 133-135.

26 See El-Gamal, Mahmoud (2000), An Economic Explication of the Prohibition of Gharar in Classical Islamic Jurisprudence, available at: http://www.ruf.rice.edu/elgamal, Internet, last accessed at 01/04/2000, p.9.

27 The Quran: al-Baqarah [2:219].

profits for the investor in the short-term, however, the impact resulting from such an investment on the economy is certainly more severe.

In this perspective, the significance of long-term investing emerges. Fisher (one of the founders of Value Investing) is fascinated with the intrinsic value over the long-term, especially due to the risk and the value-added resulting from long-term investing on the economy.[28] Buffett also believes that by extending the time horizon out to several years, the probability of it being a risky transaction dramatically decreases, and that is under the assumption that the investor made a sensible purchase.[29] In addition, it has been proven, in chapter (7), how investing in stocks in the long-term is less risky and more profitable than investing in other type of securities.

In general, day traders and other speculators employ Technical Analysis. These participants attempt to manipulate market-generated data to predict the directional movements in prices. Technical analysis usually involves examining charts of historical prices, records of trading volumes and other varied methods to assess the trend and momentum of a particular stock. Traders who perform technical analysis assume that history tends to repeat itself. And in most cases, these market participants lay aside employing any other analysis e.g. fundamental analysis. From an Islamic perspective, this type of analysis is associated with three main problems. First, the focus of market participants who only apply technical analysis is limited to future price trends, and by this these participants do not assess the fundamentals of the firms. These participants do not assure that the business of the potential firm is inline with

28 Hagstron, Robert (1999), The Warren Buffet Portfolio, John Wiley & Sons Inc. p.30.
30 Ibid.

guidelines of Islamic investing, and because of that, they might put their money in firms that promote gambling, or produce alcoholic beverages and so on, and that is prohibited from an Islamic perspective. In addition, these market participants might be highly involved with firms that significantly deal with interest-rate based transactions, starting from commercial banks and insurance firms and ending up with firms that are highly leveraged with interest-based transactions, and this again contradicts the guidelines of Islamic investing. The second problem is directly related to *gharar*. The focus of market participants who only employ technical analysis is limited to price trends. These participants do not assess and evaluate the different types of risk associated with engaging in a particular stock. Consequently, these participants are ignoring the principle of causality that has been discussed in the beginning of this chapter. In other words, these participants are not undertaking the appropriate causes, and this contradicts the basic tenets of the different sources of Islamic contract law and ultimately leads to *gharar*. Third, the trading attitudes of market participants that only employ technical analysis might impact the economic performance. Many studies highlight the negative impact of short-term investing on the economy, especially when it comes to those market participants whose stock trades are fully dependent on price speculation e.g. day traders. Such trading acts causes the misallocation of cash money: "siphoning out" the "productive sectors" in the economy and "wasting" corporate earnings on commissions and costs related to "frivolous trading".[30] Tia reveals that day traders are increasingly affecting the stock market's performance. [31] Silkunas pictures day trading process as: "... more closely

30 Sachapiro, Mary (1999), Testimony on the Securities Day Trading Industry, before the Permanent Subcommittee on Investigations, Senate Committee on General Affairs, Sep, available from: http://www.sec.gov/investor/pubs/daytips.htm, Internet; last accessed at 03/03 /2001.
31 See Brien, Tia (2000), The Day Trader Blues, Upside, Foster City-USA.

related to off-track betting, casinos, and gaming halls than it is to investing."[32] There is no doubt that short-term stock investing - especially day trading - is a risky speculative activity, and even the most experienced day traders may suffer severe and unexpected financial losses.[33] In addition, day traders enhance the degree of volatility in stock markets, because they simply profit from short-term swings occurring in stock prices, and hence, the more volatile the stock market, the more it leaves a negative impact on the economy. Consequently, by referring to the concept of Objectives of Islamic Law (*maqasid al-shariaa*), short-term and such like acts are supposed to be prohibited in Islam. The following verse from the Quran is inline with the latter argument.

> O you who believe! do not devour your property among yourselves falsely, except that it be trading by your mutual consent; and do not kill your people; surely Allah is Merciful to you.[34]

Market participants that employ Fundamental Analysis attempt to identify and project the actual value of the firm. This is achieved by projecting the corporate profit growth and value of earning projections, which requires setting appropriate a (price/earnings) ratio and other multiple ratios as targets. In this context, the worth of stocks is sensible to both the expectations of future earnings as well as the required rate of return used to discount the earning expectations.[35] Consequently, these market participants compare the calculated value with the current market value of the firm. Based on this analysis the investor decides to buy, hold, or sell the stock. For instance, if the calculated value of the firm is less than the current market value of the firm, the

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32 Silkunas, Steven (2001), Day Trading on the Edge: A Look Before You Leap Guide to Extreme Investing, Library Journal, Jan, Vol. 126, Issue 1, New York-USA., p.126.

33 Sachapiro, Mary (1999), Testimony on the Securities Day Trading Industry, before the Permanent Subcommittee on Investigations, Senate Committee on General Affairs, Sep, 1999, available at: http://www.sec.gov/investor/pubs/daytips.htm, Internet, last accessed at 01/04/2001.

34 The Quran: an-Nisa' [4:29].

35 Jahnke, William (1998), Valuing the Dow, Journal of Financial Planning, Vol. 11, Issue 5, Denver-USA, pp. 38-41.

stock is considered a good buy. This type of analysis attempts to limit the risk that the investor might be taking if the stocks are overvalued and this is an appropriate cause from an Islamic perspective, taking into consideration that the investor is fully aware that the resulting assessment might not be realized. Al-Suwailem asserts that:

> The cause is valued in its own because its usefulness is not limited to a single trial or a particular instance, where the valuable outcome may or may not be realized. Rather, it is based on a priori information that such an act, overall and in general, leads to the desired return. This explains what might at first glance appears as a contradiction; namely that the value of the cause is certain while its effect is uncertain. The reason is that describing an act *x* as a cause for result *y* does not mean that for every occurrence of *x* the result *y* will follow. It's a probabilistic relationship whereby x, more likely than not, leads to y. [36]

So far, it can be observed that the many concepts suggested by the Value Investing approach are to a certain extent inline with the basic tenets derived from the different sources of Islamic contract law. However, from a technical perspective, this approach failed to explore risk in the context of a portfolio of stocks. In other words, the approach is poor in suggesting how to construct a portfolio that combines several stocks in the sense of achieving highest return with the least risk possible. At this juncture, the importance of Modern Portfolio Theory (MPT) emerges.

The followers of MPT demonstrate that rational investors choose to hold efficient portfolios by maximizing expected return for a given degree of risk, and by minimizing risk for a given level of expected return. [37] This "portfolio effect" is a consequence of the imperfect correlation of returns between different types of securities. In fact, the lower these correlations are, the greater the reduction in risk. A well-diversified portfolio consists of only unavoidable economy-wide risks, known as

36 Al-Suwailem, Sami (2000), Decision Under Uncertainty: An Islamic Perspective, Internet, available at: http://www.islamic-exchange.com, last accessed at 15/05/2001, p. 5.

37 See Hagin, Robert (1979), Modern Portfolio Theory, Dow Jones-Irwin, USA.

market or systematic risk.[38] The edge of this approach emerges from differentiating between two types of risks: - systematic and non-systematic. Unsystematic (controllable) risk, which refers to the risk associated with the firm's operations, can be reduced through diversification i.e. having diversified investments in a portfolio. It can be argued that the idea of diversification can be useful for the purpose of reducing *gharar*.

With regard to systematic (controllable) risk, it is defined as the risk(s) that are associated with market dynamics, which are beyond the control of the investor.[39] For the purpose of avoiding *gharar*, the Muslim investor's focal point is supposed to be limited in the direction of controllable (avoidable) risk. Noting that the suggested definition of *gharar*, as appeared in chapter (4), is in terms of avoidable risk. A Muslim scholar asserts:

> In Islamic culture, uncertainty is strongly linked to causes. Once we face an uncertain decision problem, we usually think that one shall perform the cause and leave the final result to the will of Allah, the Almighty. This inherent behavior is well established in Islamic principles, with the saying of the Prophet, peace be upon him, regarding the Arabian's camel: "Tie it and entrust" ... The cause, tying the camel, addresses controllable risk, while entrust (*twakkul*) addresses uncontrollable risk.[40]

The MPT also suggests beta as a method of estimating the risk a particular stock will add to a portfolio of stocks. To a certain extent, this ratio can be used for the purpose of reducing *gharar*. Note that a Muslim investor must ensure that the selected

39 Hichman, Kent, Teets, Walter and Kohls John (1999), Social Investing and Modern Portfolio Theory, American Business Review, Jan, Vol. 17, Issue 1, West Haven-USA, pp. 72-78.

40 Cassell, Merrill (1999), Risk and Return, Management Accounting, Vol. 77, Issue 9, pp. 22-25.

41 Al-Suwailem, Sami (2000), Decision Under Uncertainty: An Islamic Perspective, Internet, available at: http://www.islamic-exchange.com, last accessed at 15/05/2001, p.4.

benchmark or proxy is an Islamic permissible (*halal*) one, and that is instead of using the S&P 500 and other conventional indexes. The problem with using the S&P 500 and other major conventional benchmarks is that they include many “invalid Islamic” stocks e.g. stocks of financial firms, alcoholic producing firms, and casinos. Providentially, the recent emergence of the Islamic Dow Jones Stock Market Index in addition to the FTSE Global Islamic Indices can be used as proxies and benchmarks for the purpose of measuring beta, even though these indexes might not be comprehensive enough.

It can be argued that Value Investing and MPT fall short of assessing any non-fundamental conditions. Assuming that the firm’s prospects suffer a setback as a result of either a firm-specific event or an overall economic downturn, usually investors in such an event sell their stocks, and this further drives down the price of the stock. However, this is not supposed to happen in the case of Muslim investors. It can be argued that Muslim investors can learn much from contemporary stock valuation models and this is in the sense of evaluating risk and other financial matters. However, when it comes to analyzing the non-financial matters of the firm, Muslim investors are supposed to have their way or style of investing. Muslim market participants might need to focus additionally on stock of firms that follow the different aspects of Islamic contract law, and once these firms are founded, Muslim investors are supposed to support the firms they invest in especially in the case of out of control setbacks. Muslim investors are supposed to believe in long-term investing and are more concerned with the intrinsic value over long-term periods. This ultimately limits the negative impact resulting from excessive selling by the majority of investors during setbacks, which occurs in the case conventional investing. One of the central concerns Muslim investors need to consider is the extent these firms are committed to Islamic values. Perhaps in this context, Muslims need to benefit from the experience of so called Corporate Social Responsible (CSP), which is defined as: "a business organization's configuration of principles of social responsibility, processes of social responsiveness, and policies, programs, and observable outcomes as they relate to the firm's societal relationships". [41] Wood and Jones argue that stakeholders should be the focus of CSP since they have a significant impact on the firm. [42] Also Boal and Peery assert that the management's of "socially responsive firms" are suppose to make strategic decisions, which are economically feasible and must affect all stakeholders in a just manner.[43]

It is worth indicating that one of the major challenges associated with the existing screening criteria of IEFs is that they fall short of assessing the firm's Islamic performance. In other terms, the objective of current screens is assuring that the selected stocks are *halal*, and, hence not necessarily Islamic[44]. For instance, the current screens do not indicate the extent to which the firm is involved in issues such as charitable giving, environmental emissions, employees' benefits, and community involvement. From this point stems the importance of modifying the current screening criteria of IEFs to include particularly positive aspects.

41 As cited from Stanwick, Peter A and Stanwick, Sarah (1998), The Determinants of Corporate Social Performance: An Empirical Examination, American Business Review, Jan, Vol. 16, Issue. 1, p. 87 (86-93)

42 See Wood, D. and R. Jones (1995), Stakeholder Mismatching: A Theoretical Problem in Empirical Research on Corporate Social Performance, The International Journal of Organizational Analysis, Vol. 3, pp. 229-267.

43 See Boal, K. and N. Peery, (1985), The Cognitive Structure of Corporate Social Responsibility, Journal of Management, Vol. 11, pp. 71-82.

44 Note that "Islamic" is a broader concept than "halal".

8.4 Appropriate Value of Risk Measurement Ratios and the Case of *Gharar*

In chapter (7), a number of financial ratios derived from both different conventional valuations models have been suggested. These can be used as for the purpose of *gharar* reduction. The question that emerges in the context, is what is the appropriate and acceptable degree (on numerical basis) of these ratios? To answer this question it is essential to refer to what has been emphasized on by Tirmidi; "*Al-Kharaj bi-al-daman*", [45] which literally means "Gain accompanies liability for loss". A common interpretation of this *hadith* is that in order for Muslims to earn a *halal* profit from a particular transaction, the risk of loss must accompany this transaction. Vogel and Hayes indicate:

> Since exposure to risk is what justifies profit, efforts to shift that risk to another party may be disapproved. Some forms of risk shifting are legitimate, however, but not if they lead to gambling or excessive speculation.[46]

The *Al-Kharaj bi-al-daman* might be used as a way of confining the boundaries of *halal* and non-*halal* degrees of risk. For instance, Muslims are prohibited from investing in T-bills and other types of bonds and bills issued by the governments. That is because Muslims are prohibited from receiving guaranteed return or income, and hence, any income must be accompanied with the liability for loss, and this is not the case of bonds and T-bills issued by governments, especially those ones issued by top rated Western governments.

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45 Sahih (authentic) Hadeith narrated by Ahmad, Abu Dawud, Al Termizi, Al Nisa`i, Ibn Majah and Ibn Hayan. See Ibn Nujaym's Ashbah wa Naza`ir.

48 Vogel, Frank and Hayes Samuel (1998), Islamic Law and Finance; Religion, Risk, and Return, Kluwer La International, Massachuestts-USA. p. 292.

If we also refer back to chapter (6), it can be observed that the main justification behind prohibiting derivatives and contemporary hedging instruments in Islam, is that these might be associated with significant risk and uncertainty, especially when they are used for speculation and gambling purposes. Therefore, it can be understood that transactions associated with significant risk are also prohibited from an Islamic perspective due to *gharar*. Another example that is in line with the suggested argument is the case of the *mudaraba* contract. This contract is always being recommended by Muslim scholars due its consistency with the basic tenets of Islamic contract law. By taking a close look on the degree of risk associated with *mudaraba*, it is neither significant nor insignificant. For the investor (*rub al mal*), the risk is not insignificant because in the case of loss he will be the only party bearing the risk of loss, by losing the total invested amount in the project. For the agent manager (*mudarab*), his loss is limited to his contributed efforts. Consequently, the investor puts all of his eggs in the agent manager's basket. Nevertheless, the risk is insignificant because the investor's loss is limited to the amount invested only. In other words, the investor's liability in the *mudaraba* contract is not beyond the initial amount invested in the project. In addition, it is worth noting that the risk in *mudaraba* is reducible i.e. the investor has the privilege and right to ensure the feasibility of the project and the agent manger's managerial capabilities. As a result of the latter arguments, it can be concluded that a tolerable degree of risk from an Islamic perspective is moderate i.e. nor significant or insignificant.

In general, suggesting a moderate or average degree of risk is to a certain extent in line with the different sources of Islamic contract law. For instance, God describes the Muslim nation as a middle one. The following verse illustrates this issue:

> Thus We have appointed you a middle nation, that ye may be witnesses against mankind, and that the messenger may be a witness against you.[47]

Obviously there is a problem in judging what is "significant" or "moderate". Taking into consideration that *shariaa* scholars might take varying views; the dissertation presents a number of different perspectives. Alternately there can be no clear objective definition.

Suggesting a moderate degree of risk can be sufficiently utilized for reducing and indicating *gharar*. With regard to beta, it is suggestible that the acceptable value needs to be around the average, and, hence there is no specific figure that can be recommended, since the issue is dependent on the high and low of each sector in the economy, aware that these values usually differ from one sector to another. In this case, the proposed argument suggests that the investor must be very hesitant to invest in a stock with a beta equaling zero, because of the guaranteed return issue that has been discussed previously. Also, there is a problem of investing in a firm that has a beta of two, that is due to excessive speculation and gambling issues, which ultimately lead to the *gharar*. Noting that the figures zero and two are assumed to be the lowest and the highest for a particular stock market sector.

With regard to price multiple e.g. P/E; assuming that the minimum P/E ratio for the car manufacturing industry equals 10 times and the maximum is 40 times, according to the proposed assumption, the Islamic valid P/E for such industry is around 25 times. Because investing in high P/E ratios is associated with high risk, taking into consideration that high P/E ratios are usually those highly valued stocks. On the other

47 al-Baqarah [2:143.7].

hand, low or very low P/E ratios are regarded as notably under-valued stocks, and usually firms with notably low P/E ratio are those that have problems with their annual earnings.

The end argument is that one of the ways of avoiding *gharar* in stock investing, is avoiding investing in stocks associated with significant avoidable risk and stocks associated with high uncertain outcomes. Consequently, the different measures of risk derived from contemporary valuation models can be used as indicators for stocks associated with significant risk. The outcome of these measures must be moderate in order to avoid falling in *gharar*. In addition, it is important to assure that the values of these ratios and multiples must be calculated on a relative basis. Aswath asserts that:

> In relative valuation, the value of an asset is derived from the pricing of "comparable" assets, standardized using a common variable such as earnings, cash flows, book value, or revenues. One illustration of this approach is the use of an industry-average price/earnings ratio to value a firm, the assumption being that the other firms in the industry are comparable to the firm being valued and that the market, on average, prices these firms correctly.[48]

48 Damodaran, Aswath (1996), Investment Valuations, John Wiley & Sons, Inc., p.13.

CONCLUSION

Muslims' engagement in financial stock markets, and more particularly in stock investing, is expected to continue surging for several reasons. First, in the light of the globalisation impact on stock markets and the financial services sector, which mainly consists of the deregulation of local and international stock markets, and the significance of high technology in the financial services operations. Secondly, the anticipated demand generated from the 1.2 billion Muslims around the world, specifically those institutional investors and wealthy individuals that are based in the Arab Gulf region. Thirdly, the significant increase in the number of Islamic Equity Funds during the last five years. As a result of these reasons, the significance of including *gharar* to the screening criteria used by Muslims to screen out unlawful stocks certainly emerges.

The different sources of Islamic contract law clearly emphasise that income earned by Muslims must be *halal*. For instance, God in the following verse mentions:

> O people, eat from the earth's products all that is lawful and good, and do not follow the steps of Satan; he is your most ardent enemy. [1]

It is possible to narrate this verse by arguing that dealing with stocks is one of the earth's products and Muslims are obliged to trade these stocks in a lawful and good manner. The members of *Shariaa* Supervisory Boards of Islamic Equity Funds have explicitly and implicitly allowed Muslims the direct involvement in investing in stocks. Muslims are allowed to buy, sell or hold stocks, all under one condition; the selected stocks must be consistent with the guidelines derived from the different sources of Islamic contract law. The focus of the current screening criteria of Islamic

1 The Quran: al-Baqarah [2:168].

Equity Funds is limited to: *riba* and impermissible operations. These guidelines clearly ignore *gharar,* despite that different sources of Islamic contract law impose strict restraints on all commercial transactions that consist of *gharar*. Legal Muslim jurists agree that a contract may be null and void, based on the existence of *gharar*, thus there is a conflict of opinion in the exact definition of *gharar* and what degree is required to retain the contract's validity. In addition, *gharar* in terms of stock investing has not been tackled extensively by previous Muslim scholars.

The members of the *Shariaa* Supervisory Boards (SSBs) also have a vital role to play in improving the current screening criteria of IEFs. The following lines illustrate more on this issue. First, it is recommended that the members of the SSB start employing more advanced screening strategies such as positive screening rather than being limited to negative screening. In this context, very much can be learned from ethical equity funds which are mainly promoted in Western countries. Secondly, several modifications need to be applied on the current screening criteria of IEFs. The purpose behind these modifications is measuring the extent to which a particular public listed firm is committed to the Islamic values. Thirdly, it is important to have unified screening criteria of IEFs. Despite its complexity, it is hoped that this unified screen will be fully approved from the *shariaa* scholars pertaining to different schools of *fiqh*. Fourthly, it is also hoped that the members of the SSB include *gharar* in the screening criteria of the funds in which these *shariaa* scholars are advising.

Gharar in terms of stock investing has been defined as "the avoidable risk resulting from transactions associated with significant and unnecessary uncertain outcomes." One of the major implications of this definition is that *gharar* is limited to avoidable types of risk. In order for the investor to avoid *gharar* in the context of stock investing, he or she needs to focus on avoidable risk related issues, being aware that avoidable risk is the risk that can be controlled by the investor. It is important that Muslims focus on the causes in a proper manner. In order for Muslim investors to avoid *gharar* they should not rely on pure chance in achieving the desired profit or return. On the contrary, the investor should focus on the causes that lead to profit excluded from *gharar*. Most important, the study of these causes must be within the boundaries of Islamic law.

Muslim investors are able to reduce avoidable risk i.e. *gharar*, by not being engaged in short-term stock investing, and especially day trading. Day traders enhance the degree of volatility in stock they tend to profit from short-term swings occurring in stock prices, and hence, the more volatile the stock market gets, the more it negatively impacts the economy stability.

Another approach of avoiding *gharar* is by not employing the different types of derivatives, because all conventional derivatives are prohibited in Islam due to *gharar* and many several issues. Also, referring to investment professionals or investing in particular indexes and equity funds might by considered as a way of dealing with *gharar*. In addition, several concepts, tactics and ratios can be employed for *gharar* reduction purposes, noting that Muslim investors are advised to pursue these tactics in order to avoid counting on chance to achieve the desired outcome, which is the essence of gambling and *gharar*.

A number of the different types of valuation models of risk reduction have been suggested. These models include value investing, modern portfolio approach and derivatives. As for derivatives, Muslims are prohibited to employ the different types of derivatives. With regard to the value investing approach, it has been observed that many concepts of this approach are to a certain extent in line with the guidelines of Islamic investing. For instance, value investors employ fundamental analysis e.g. different multiple ratios, for the purpose of quantifying the intrinsic value of a particular firm. For these investors, engaging with overvalued stocks of firms is regarded as risky. Value investors also believe that risk is linked with the investor's time horizon, and hence, one of the ways of reducing risk is investing for long-term periods. One of the important observations is related to Siegel's historical calculations. These calculations concluded that stocks in contrast to bonds or bills, have never offered the investors a "negative" real return for periods that are over seventeen years, and for long periods stocks are less risky in comparison to the other two types of securities. These latter tactics can certainly help the Muslim investor in limiting *gharar* in terms of stocks.

Value investing approach is poor in suggesting how to construct a portfolio that combines several stocks in the sense of achieving highest return with the least risk possible. The MPT fill this gap by proposing the so called "portfolio effect". One of the implications of this effect is investing in index funds or in the different types of stock (equity) funds. Also MPT differentiates between two types of risks: systematic and non-systematic. As for unsystematic (controllable) risk, it can be reduced through diversification. The idea is that *gharar* can be reduced by diversification. Muslim investors can also benefit from beta, which can be used to measure the additional risk resulting from adding a particular stock to the portfolio, aware that a number of modifications has been suggested to make beta more compliant with Islamic investment guidelines. It was also suggested that the outcome and value of the proposed measures i.e. ratios, must be moderate in order to avoid falling into *gharar*. In addition, it is important to assure that the values of these ratios and multiples must be calculated on a relative basis.

It is important to indicate that the certain different tactics and ratios derived from value investing and the modern portfolio approach were found very helpful in reducing *gharar* in terms of stock investing, however, the both latter can not serve as a complete concrete model for *gharar* detection and reduction. Hence, these models fall short of assessing any non-fundamental conditions. The thesis demonstrated that there are certain cases where investing in a particular stock is being justified despite that the stock might involve *gharar*, and this is due to *masalahah*. These cases occur especially when there are firms fully committed to the Islamic values but for a temporary period, the stocks of this firm have been involved in *gharar*.

One of the central concerns Muslim investors need to consider is the extent to which a particular firm is committed to the Islamic values. Unfortunately, the current screening criteria of Islamic Equity Funds and indexes fall short of assessing the firm's Islamic performance. The regulators of financial stock markets can play a significant role in curbing *gharar*. The following lines suggest a number of recommendations for this purpose. First, the regulators are advised to set up price ceilings or limits on all public listed stocks. These limits help in increasing the stability of stock markets. Secondly, the regulators need to educate stock market participants about the ways and tactics that can be employed for *gharar* reduction. Thirdly, the regulators might need to consider imposing a number of strict regulations for the purpose of prohibiting any acts and financial transactions that leave a negative impact on other stock market participants such as insider trading and day trading. Finally, the regulators; especially in Muslim countries, are advised to force the management's of public listed firms to publish comprehensive and up to date financial information on their firms. Such information enables stock market participants to successfully evaluate the fundamentals and other related issues of any potential firm.

Recommendations for Future Research

The contemporary literature on the subject of *gharar* is limited, and when it comes to the topic of *gharar* in terms of stock investing the literature becomes extremely scanty. This is despite the significance of *gharar* among the writings of the previous Muslim Jurists who pertain to the different four *fiqh* schools. There is no dispute among the Muslim scholars that *gharar* is impermissible. However, scholars are still unable to translate *gharar* in terms of stock investing. The purpose of this thesis was setting a foundation for solving the dilemma of *gharar* in terms of stock investing. It is hoped that future researches will benefit from the main conclusions of this thesis, starting from defining *gharar* in terms of stock investing, and ending with suggesting a number of strategies, tactics and ratios that help the investors in avoiding *gharar* in terms of stock investing.

In order to obtain the best results from this thesis, it is hoped that a Muslim Jurist will take the research further by ensuring that the resulting conclusions are in line with the basic tenets of Islamic contract law, and this is expected to give more credence to the outcomes of the thesis. It is also worthwhile to receive some feedback from both the Islamic bankers and Muslim investors on the outcome of this thesis, which will add to its practicality. One of the important topics that need to be tackled is examining what are the results of including the suggested ratios to the screening criteria of Islamic Equity Funds, in other words, determining if the inclusion of these ratios will dramatically reduce that number of Islamically qualified stocks or not. A potential further study directly related to thesis topic is examining the financial performance of stocks that are associated with *gharar* and those that are not.

It is also worthwhile to conduct a study that measures the financial performance of Islamic Equity Funds, especially with the recent emergence of Islamic Equity Indexes, which can be used as appropriate benchmarks. In addition, further studies need to be conducted on the strategies of screening criteria of Islamic Equity Funds and indexes. In this particular aspect, there is plenty to learn from the screening criteria of the Western social and ethical equity funds. Last but not least, a potential study will be assessing the feasibility of employing the current screening criteria of Islamic Equity Funds and indexes on the stock markets of Muslim markets, taking into consideration that the firms included in these stock markets are highly engaged in interest based transactions, and most importantly investing in these firms is regarded as high risk.

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